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CCOUNTANCY

A TEXTBOOK
FOR THE PROFESSIONAL ACCOUNTANT AND ADVANCED COMMERCIAL EXAMINATIONS

BY

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SECOND EDITION

IN CONJUNCTION WITH

G. W. DUNKERLEY

M.C., A C.A.

LONDON
SIR ISAAC PITMAN & SONS, LTD.

First edition 1934
Reprinted 1940
Reprinted 1946
Second edition 1950
Reprinted 1951
Revised and reprinted 1954

SIR ISAAC PITMAN & SONS Ltd
PITMAN HOUSE, PARKER STREET, KINGSWAY, LONDON, W.C.2
THE PITMAN PRESS, BATH
PITMAN HOUSE, LITTLE COLLINS STREET, MELBOURNE
27 BECKETTS BUILDINGS, PRESIDENT STREET, JOHANNESBURG

ASSOCIATED COMPANIES
PITMAN PUBLISHING CORPORATION
2 WEST 45TH STREET, NEW YORK
SIR ISAAC PITMAN & SONS (CANADA) Ltd
(INCORPORATING THE COMMERCIAL TEXT BOOK COMPANY)
PITMAN HOUSE, 381-383 CHURCH STREET, TORONTO

MADE IN GREAT BRITAIN AT THE PITMAN PRESS, BATH
I 4—(B 2083)

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CHAPTER I

BOOK-KEEPING TO THE TRIAL BALANCE

THE system of book-keeping which is almost universally employed that whereby "every debit has a credit." This is known as the Double Entry System, to distinguish it from the Single Entry System, a much less detailed and less accurate method now very little used. The principles of Single Entry and its disadvantages, a knowledge of which is essential for examination purposes, are dealt with in Chapter XI.

The Double Entry System seeks to record every transaction in money or money's worth in its double aspect—the receipt of a benefit by one account and the surrender of a like benefit by another account, the former entry being to the DEBIT of the account receiving, the latter to the CREDIT of the account surrendering. The fact that every debit has a credit does not necessarily entail the task of literally entering a separate credit for each debit, as, by the employment of special books, and the utilization of the totals of all entries contained therein, certain debits will be reflected, not in a series of separate credits but in a composite or collective item. Following the same principle, certain credits will be reflected in a composite or collective debit entry.

The student should find no difficulty in the entries in the Ledger accounts if he remembers the "three cardinal rules" of double-entry book-keeping, viz.—

1. **Real Accounts,** i.e. accounts relating to tangible things, such as Cash, Fixtures, and Goods. "Debit what comes in: Credit what goes out."

2. **Personal Accounts,** i.e. accounts relating to transactions with persons necessitated by "Credit" transactions, i.e. where goods are sold and services rendered, payment being made at a subsequent date, or in the case of "Debit" transactions where the converse position arises, i.e. payment is made at once for the future delivery of goods or rendering of services. "Debit receiver: Credit supplier."

3. **Nominal Accounts,** i.e. accounts relating to gains or losses, e.g. Rents, Discounts. "Debit losses (or expenses): Credit gains."

As the first principle of double entry is that every entry in the Ledger shall be the subject of an originating entry in a book of prime or original entry, it is necessary as a preliminary to outline briefly the books of prime entry usually met with. These are as follows—

1. Journal.
2. Purchases and Sales Day Books.
3. Purchases and Sales Returns Books.

In addition may be included the Cash Book, which though strictly part of the Ledger, is, in practice, employed as a book of prime entry.

The books will be considered separately.

1. **The Journal.** This book is employed for (*a*) opening entries, (*b*) closing entries and (*c*) transactions of a special nature. It should be borne in mind that *every* transaction is capable of entry in the Journal, but in order to economize labour, other books are almost invariably employed in place of the Journal.

The rule to be employed in writing up the Journal is to enter in the debit column thereof the amount which is to be entered on the debit side of the Ledger, and in the credit column the amount which is to be entered on the credit side of the Ledger. The title of the appropriate account will be entered against each item. It is thus necessary to visualize the entry as it will appear in the Ledger, and to enter the items accordingly in the Journal. The amount in the debit column must equal that in the credit column either in separate items or in a composite item.

At the foot of each entry a note, called the narration (or narrative), must be appended, showing the nature of and, where necessary, the authority for, the entry.

The entries made upon the inauguration of a business are—Debit assets: Credit liabilities and CAPITAL. These initial entries must balance simply because Capital is the excess of Assets over Liabilities. This rule is only a modified expression of the rules outlined on page 1, as Assets are usually Real Accounts, and as they come into the business are therefore debited. If some of those Assets consist of Debtors, they are personal accounts and are consequently debited as the persons in question have received goods and/or services from the proprietor at some time; as regards the credit entries, liabilities and capital are Personal Accounts and are credited in accordance with the rule appropriate thereto, i.e. credit supplier.

2. **Sales and Purchases Day Books.** Each sale (ignoring Cash Sales) will be entered in the Sales Day Book with such details as are required, e.g. date, name, reference to duplicate invoice, and posted to the debit of the buyer's account in the Ledger (Personal Accounts: debit receiver). At the end of a suitable period, weekly, monthly, or in fact at any interval, provided that it does not overlap the period for which the final accounts are to be prepared, additions of all the entries in the Sales Day Book will be made, and the total posted to the credit of Sales Account. (Real Accounts: credit what goes out.)

When this has been done the double entry in the Ledger has been effected in that the individual debits to the Personal Accounts are balanced by the total credit to the Sales Account.

Purchases will be similarly recorded but posted to the *credit* of the supplier's account in the Ledger (Personal Accounts: credit supplier). The total of the Purchases Day Book will be posted

periodically to the *debit* of Purchases Account (Real Accounts: debit what comes in).

Particular attention must be paid to the method of dealing with trade discounts. These are adjustments of the listed price of goods, and should be deducted *before* the sale or purchase is entered in the Day Book in order that this entry may represent the true sale or purchase price. Any *cash* discount allowed will be based upon the true figure, i.e. after deducting trade discount.

With regard to Cash Sales and Purchases, three alternative methods are usually met with, viz.—

(1) To enter them in the Cash Book, debiting Cash and crediting Cash Sales Account, or crediting Cash and debiting Cash Purchases Account. By using a separate column in the Cash Book, posting to Cash Sales (or Purchases) Account can be made in total.

(2) To enter the transaction in the appropriate Day Book in the same way as a credit sale or purchase, and to post the amount to the debit or credit respectively of Cash.

(3) To enter the transaction in the appropriate Day Book and post to the debit (sales) or credit (purchases) of a ledger account called Cash Sales (or Purchases) (Personal) Account, exactly as if it were a credit transaction.

3. **Sales and Purchases Returns Books.** These books occupy the converse position to the Day Books, all postings being made, in respect of Sales Returns, to the *credit* of the account of the customer who returns goods (Personal Accounts: credit supplier), and in respect of Purchases Returns, to the *debit* of the account of the supplier to whom the goods are returned. The respective totals are posted periodically to the debit of Sales or Sales Returns Account, and to the credit of Purchases or Purchases Returns Account.

In these books the treatment of trade discounts will be similar to that in the case of Sales and Purchases; that is, the amount to be entered will be the net figure *after* deduction of trade discount.

Cash Book. It will be recollected that one of the fundamental rules of double-entry book-keeping is that all entries must originate in a subsidiary book—a book of prime or original entry—and be posted therefrom to the Ledger. In practice, however, expedience and convenience dictate a departure from this rule in the case of cash and bank entries.

The Cash Book is a LEDGER, but the use of a subsidiary book in this connection is often dispensed with, and the double entry is completed by direct transfer from the Cash Book to the other ledgers.

The type of Cash Book employed depends largely on the circumstances, but for the purpose of exposition of principles the usual "three-column" type will be taken. It should be noted that the three columns which appear on each side of the Cash Book represent the three types into which accounts are classified—

(1) Discount, which is a NOMINAL ACCOUNT.

(2) Cash, which is a Real Account.
(3) Bank, which is a Personal Account.
The principal rules are as follows—

Receipts.

(*a*) On receipt of cash from debtors, the amount actually received is entered in the Cash column *debit* (Real Accounts: debit what comes in) or if the money is paid direct into the Bank, into the Bank column *debit* (Personal Accounts: debit receiver). The credit in each case is to the debtor's Personal Account (Personal Accounts: credit supplier).

(*b*) On receipt of an amount in respect of Cash Sales, the entry is made in the Cash or Bank column *debit*, the *credit* in this case being either to the Cash Sales Account, or as a posting to the Sales Day Book, or to the credit of Cash Sales (Personal) Account. (See page 3.)

(*c*) On receipt of an amount from the sale of an Asset, the entry will be to the debit of Cash or Bank as outlined above, whilst the credit will be to the Asset Account (Real Accounts: credit what goes out).

In all the above cases, if a Cash Discount is allowed, such amount is entered in the Discount Allowed column *debit*, this column being totalled periodically, and the total *transferred* to the *debit* of Discounts Allowed Account (Nominal Accounts: debit loss or expense).

Payments.

(*a*) On payment of an amount by cash to a creditor, the amount is entered in the Cash column *credit* (Real Accounts: credit what goes out); if the payment should be made by cheque, the amount is entered in the Bank column (instead of Cash) *credit* (Personal Accounts: credit supplier), the *debit* in each case being to the creditor's Personal Account (Personal Accounts: debit receiver).

(*b*) On payment of an amount in respect of Cash Purchases, the entry is made in the Cash or Bank column *credit* (rule as above), the *debit* in this case being either to Cash Purchases Account, or as a posting to the Purchases Day Book, or to the *debit* of Cash Purchases (Personal) Account. (See page 3.)

(*c*) On payment of an amount for the purchase of an Asset, the *credit* will be to Cash or Bank, whilst the *debit* will be to the Asset Account (Real Accounts: debit what comes in).

In all the above cases, if a Cash Discount is received, such amount is entered in the Discount Received column *credit*, this column being totalled periodically, and the total *transferred* to the *credit* of Discounts Received Account (Nominal Accounts: credit gains).

Bank. Where Cash is paid into the Bank, the entries will be: *Credit* Cash column (Real Accounts: credit what goes out) and

debit Bank column (Personal Accounts: debit receiver) unless on receipt it was paid into Bank and entered direct into the Bank column debit. If Cash is drawn out of the Bank for use in the business the entries will be exactly opposite, viz. *debit* Cash column (Real Accounts: debit what comes in), and *credit* Bank column (Personal Accounts: credit supplier).

The Ledger. The Ledger is the most important book of account and is the destination of the entries made in the subsidiary books. It is essentially a collection of the three types of accounts already enumerated—Real, Personal and Nominal. Real Accounts record transactions which deal with material things. Assets such as Cash and Stock are typical examples.

Personal Accounts record transactions of a personal nature. It should be noted that while Cash is a real account, Bank is a personal account.

Nominal accounts relate, on the one hand, to all gains, and on the other hand, to all losses, costs, and expenses connected with the particular business. Examples of nominal accounts are: Wages, Rent, Rates, Taxes, Insurance, Carriage, Discount, Telephone, Depreciation and Interest. The debits (i.e. losses, etc.) will usually have their original entry in the Cash or Bank column of the Cash Book, Purchases Day Book or the Expenses Day Book, the latter book being used to record expenses on similar lines to the Purchases Day Book.

In concerns of any magnitude, the Ledger is divided up into many separate books. There will be Sales Ledgers and Purchases Ledgers containing the accounts of Debtors and Creditors respectively, which in turn may be subdivided alphabetically, geographically or otherwise, in accordance with the requirements of the particular business.

In addition, a separate Ledger, known as the Nominal (or General) Ledger, will be utilized, containing the accounts relating to Sales, Purchases, and Expenses. In practice a Private Ledger is employed in order to ensure privacy in regard to such accounts as Capital, Drawings, Deposit Accounts at the Bank, and the like.

Drawings. Where, as is usual, the proprietor withdraws cash or goods from the business for his personal use, such amounts are in effect withdrawals of Capital. In order to free the Capital Account from a large number of small entries a Drawings Account is generally opened.

(*a*) *Cash Withdrawals.* The entries will be: *debit* Drawings Account (Personal Accounts: debit receiver); *credit* Cash (Real Accounts: credit what goes out), or Bank (Personal Accounts: credit supplier).

(*b*) *Goods Withdrawals.* The entries will be: *debit* Drawings Account; *credit* Purchases Account (Real Accounts: credit what goes out).

The balance of Drawings Account will be transferred periodically by means of a Journal entry, thus: debit Capital Account; credit Drawings Account.

Not infrequently does a payment out partake of both a nominal and a private character, e.g. entertainment expenses, and, consequently, the correct proportions (often necessarily approximated) should be charged to their appropriate accounts. It is immaterial whether the whole composite item is first debited to the Nominal or to the Drawings Account, so long as the correct adjusting transfer is made. Suppose £10 is paid out representing £6 entertainment expenses and £4 drawings, it may be treated in two ways, viz.—

JOURNAL

	Date			£	£
(1)		Drawings . . . . Dr. Entertainment Expenses . Dr. To Cash[1] . . . . . Being Drawings and Entertainment Expenses.		4 6	 10
(2)		Drawings . . . . Dr. To Cash[1] . . . . . Being Drawings.		10	 10
		Entertainment Expenses . Dr. To Drawings . . . . . Being transfer of the amount of Entertainment Expenses included in Drawings.		6	 6

Dishonoured Cheques. It frequently occurs that a cheque received in respect of a debt on which cash discount has been allowed is dishonoured (i.e. not paid), thus necessitating an adjusting Journal entry in order to restore the original position. On receipt of the cheque the following entries will have been made—

JOURNAL

			£	£
	Bank[1] . . . . Dr. Discounts Allowed . . . . Dr. To Debtor . . . . . . Being receipt of cheque and discount allowed in settlement of debt due.	(say) (say)	9 1	 10

When the cheque is dishonoured these entries must be written back, care being taken that the discount is written back to the credit of Discounts Allowed Account and *not* to the credit of Discounts Received Account through the discount column credit in

[1] In practice cash transactions are not usually journalized.

the Cash Book, as it is not a discount received but the cancellation of a discount allowed. The entries will therefore be—

JOURNAL

				£	£
	Debtor . . . . *Dr.*			10	
	To Bank				9
	,, Discounts Allowed . . .				1
	Being the writing back to Debtor in respect of cheque dishonoured and discount allowed.				

Bad Debts. If it becomes necessary to consider a debt as bad (whether a cheque has been dishonoured or not) a transfer must be made through the Journal, as follows—

JOURNAL

				£	£
	Bad Debts . . . . . . *Dr.*			10	
	To Debtor				10
	Being debt due by debtor written off as bad.				

Amounts Received from Debts Written Off. Where debts have been written off, and amounts are received subsequently in respect thereof, the entries are: (1) Debit customer, credit Bad Debts Account, (2) debit Cash, credit customer.

Illustration. A debt for £100 owing by J. Jones is written off. £50 is subsequently received.

Dr. J. JONES *Cr.*

			£				£
	To Balance . . .	b/d	100		By Bad Debts . . .		100
	,, Bad Debts . .		50		,, Cash		50

Dr. BAD DEBTS *Cr.*

			£				£
	To J. Jones . . .		100		By J. Jones . . .		50

Alternatively, cash may be debited and Bad Debts Account credited without the record in the personal account. In the foregoing illustration the posting from the Cash Account would be direct to the credit of Bad Debts Account.

The Trial Balance. It has already been seen that in the double-entry system, every debit has its corresponding credit and *vice versa*. It follows, therefore, that at any given time, the postings from the Journal, Day Books and Cash Book being completed, the debit balances standing in all the Ledgers (including the Cash Book) will equal the credit balances.

At the end of the financial period (or at some other date) these balances are extracted, and a schedule prepared in Journal form to test whether, in fact, the total debits equal the total credits. Such a schedule of balances is called a Trial Balance.

With the totals duly agreeing a *reasonably* reliable check on the *total* ARITHMETICAL accuracy of the book-keeping entries is afforded; otherwise it is obvious that some error exists either in the actual execution of the double entry or in the extraction of the balances.

Illustration. On 1st January, 19. ., A commenced business with—

	£
Cash at Bank	200
Stock	300
Furniture and Fittings	100
He owed B	150

The following were his transactions for January—

19..
Jan. 1. Withdrew £15 from bank for petty cash purposes.
Sold Y goods on credit £50.
Paid electricity deposit by cheque £2.
3. Sold L goods on credit £30.
5. Sold Q goods for cash £17, paid direct into bank.
6. Sold Y goods on credit £40.
8. Y returned goods to value of £5.
12. Bought typewriter by cheque £12.
13. Received cheque from Y in payment for goods purchased on 1st Jan., *less* 10% cash discount, paid direct into bank.
14. Bought goods on credit from D £120.
Paid wages by cash £5.
17. Bought goods from G £150, *less* 10% trade discount.
18. L pays cash £30, paid direct into bank.
20. Returned goods to G £50 (list price value).
23. A drew out of bank £40 to pay premium on his life policy. He was allowed 2½% commission by the assurance company. The net premium was paid in cash on this date.
25. Bought goods by cheque from R £15.
26. Withdrew from stock £15 goods for private purposes.
Sold to L goods on credit £20.
27. Paid B £10 cheque on account of loan, plus £2 for interest.
28. Paid electricity for month by cheque £1.
Received from L cheque for £19 in settlement of his account, paid direct into bank.
30. Cheque dishonoured and debt written off as bad.
31. Acquired second-hand car in exchange for furniture £5, goods £8, cheque £10.

At the end of the month the expenses paid out of Cash were—

Sundry Expenses	£3
Carriage	£4

Write up the books and prepare Trial Balance as at 31st January, 19... (Ignore tax.)

The following abbreviations will be used in the illustration—

C.B. = Cash Book. P.L. = Purchases Ledger.
J. = Journal. S.D.B. = Sales Day Book.
L. = General Ledger. P.D.B. = Purchases Day Book.
S.L. = Sales Ledger. S.R.B. = Sales Returns Book.
P.R.B. = Purchases Returns Book.

The opening entries and those for transactions of a special nature will be passed through the Journal—

Journal

			£	£
19.. Jan. 1	Sundries . . . . . . *Dr.*			
	To Sundries			
	Cash at Bank	C.B.	200	
	Stock	L.	300	
	Furniture and Fittings . . .	L.	100	
	B. Loan	L.		150
	A. Capital	L.		450
	Being Assets, Liabilities and Capital[1] at this date.			
26	A Drawings . . . . . *Dr.*	L.	15	
	To Purchases	L.		15
	Being Withdrawal of Goods from business for private use.			
30	L . . . . *Dr.*	S.L.	1	
	To Discounts Allowed . . .	L.		1
	Being Discount written back.			
	Bad Debts . . . . . *Dr.*	L.	20	
	To L	S.L.		20
	Being Debt written off as bad.			
31	Motor Car . . . . . . *Dr.*	L.	23	
	To Furniture and Fittings . .	L.		5
	,, Sales	L.		8
	,, Bank	C B		10
	Being second-hand car acquired in exchange for assets as above.			

Sales Day Book

			£
19.. Jan. 1	Y	S L.	50
3	L	S.L.	30
6	Y	S.L.	40
26	L	S.L.	20
			£140
			L.

Sales Returns Book

			£
19.. Jan. 8	Y	S.L.	5
			L.

[1] Capital, being the excess of Assets over Liabilities, is found by subtracting the latter (£150) from the former (£600).

Purchases Day Book

19..				£
Jan. 14	D		P.L.	120
17	G	£150		
	Less 10% Trade Discount . .	15	P.L.	135
				£255
				L.

Purchases Returns Book

19..				£
Jan. 20	G	£50		
	Less 10% Trade Discount . .	5	P L	45
				L.

Dr. **Cash Book** *Cr.*

Date		Fol	Discount Allowed	Cash	Bank	Date		Fol	Discount Received	Cash	Bank
19..			£	£	£	19..			£	£	£
Jan. 1	To Sundries . .	J.			200	Jan 1	By Electricity Deposit	L			2
	,, Bank *Contra*	C.		15			,, Cash *Contra*	C.			15
5	,, Q Cash Sale .	L			17	12	,, Typewriter	L			12
13	,, Y . .	S L	5		45	14	,, Wages	L		5	
18	,, L . . .	S L			30	23	,, Cash *Contra*	C.			40
23	,, Bank. *Contra*	C		40			,, Drawings .	L.		39	
28	,, L . . .	S L	1		19	25	,, R. Goods	L.			15
						27	,, B Repayment of Loan .	L			10
							,, B Interest	L			2
						28	,, Electricity	L			1
						30	,, L Cheque Dishonoured	S.L			19
						31	,, Sundry Expenses . .	L.		3	
							,, Carriage . .	L.		4	
							,, Sundries . .	J			10
							,, Balances c/d	C		4	185
			£6	£55	£311					£55	£311
			L.								
Feb. 1	To Balances b/d	C		4	185						

GENERAL LEDGER

Dr. **Stock** *Cr.*

19..			£				
Jan. 1	To Sundries . .	J	300				

Dr. CAPITAL *Cr.*

				19.. Jan. 1	By Sundries . .	J.	£ 450

Dr. A—DRAWINGS *Cr.*

19.. Jan. 23 26	To Cash: Life Assurance Premium . ,, Purchases . .	C.B. J.	£ 39 15				

Dr. B—LOAN *Cr.*

19.. Jan. 27	To Bank . . .	C.B.	£ 10	19.. Jan. 1	By Sundries . .	J.	£ 150

Dr. FURNITURE AND FITTINGS *Cr.*

19.. Jan 1 12	To Sundries . . ,, Bank: Typewriter.	J. C.B.	£ 100 12	19.. Jan. 31	By Sundries[1] . .	J.	£ 5

Dr. ELECTRICITY DEPOSIT *Cr.*

19.. Jan 1	To Bank . . .	C.B.	£ 2				

Dr. SALES *Cr.*

19.. Jan. 31	To Sundries . .	S.R.B.	£ 5	19.. Jan 5 31	By Cash: Q . . ,, Sundries . . ,, ,, . .	C.B. S D B J.	£ 17 140 8

Dr. PURCHASES *Cr.*

19.. Jan. 25 31	To Bank: R . . ,, Sundries . .	C B. P D.B.	£ 15 255	19.. Jan. 26 31	By Drawings . . ,, Sundries . .	J. P.R.B.	£ 15 45

Dr. LOAN INTEREST *Cr.*

19.. Jan. 27	To Bank . . .	C.B.	£ 2				

[1] An entry for profit or loss on sale may be required.

Dr. **Bad Debts** *Cr.*

19.. Jan. 30	To L . . .	J.	£ 20				

Dr. **Sundry Expenses** *Cr.*

19.. Jan. 31	To Cash . . .	C.B.	£ 3				

Dr. **Carriage** *Cr.*

19.. Jan. 31	To Cash . . .	C.B.	£ 4				

Dr. **Motor Car** *Cr.*

19.. Jan. 31	To Sundries . .	J.	£ 23				

Dr. **Electricity** *Cr.*

19.. Jan. 28	To Bank . . .	C.B.	£ 1				

Dr. **Wages** *Cr.*

19.. Jan. 14	To Cash . . .	C.B.	£ 5				

Dr. **Discounts Allowed** *Cr.*

19.. Jan. 31	To Sundries . .	C.B.	£ 6	19.. Jan. 30	By L . . .	J.	£ 1

SALES LEDGER

Dr. **Y** *Cr.*

19.. Jan. 1	To Goods . . .	S.D.B.	£ 50	19.. Jan. 8	By Returns . .	S.R.B.	£ 5
6	,, ,, .	S.D.B.	40	13	,, Cheque and Discount (£5) .	C.B.	50
				31	,, Balance . .	c/d	35
			£90				£90
Feb. 1	To Balance . .	b/d	35				

Dr. L *Cr.*

			£				£
19.. Jan. 3	To Goods . . .	S.D.B.	30	19.. Jan. 18	By Cash . .	C.B.	30
26	,, Goods . . .	S.D.B.	20	28	,, Cheque and Discount (£1) .	C.B.	20
30	,, Cheque Dishonoured .	C.B.	19				
	,, Discounts Allowed	J.	1	30	,, Bad Debts . .	J.	20

PURCHASES LEDGER

Dr. D *Cr.*

							£
				19.. Jan. 14	By Goods . .	P.D.B.	120

Dr. *Cr.*

			£				£
19.. Jan. 20	To Returns . .	P.R.B.	45	19 . Jan. 17	By Goods . .	P.D.B.	135
31	,, Balance . .	c/d	90				
			£135				£135
				Feb. 1	By Balance . .	b/d	90

TRIAL BALANCE AS AT 31ST JANUARY, 19..

		Dr. £	*Cr.* £
Stock		300	
Capital			450
A: Drawings		54	
B: Loan			140
Furniture and Fittings		107	
Electricity Deposit[1]		2	
Sales			160
Purchases		210	
Loan Interest		2	
Bad Debts		20	
Sundry Expenses		3	
Carriage		4	
Motor Car		23	
Electricity		1	
Wages		5	
Discounts Allowed		5	
Y	S.L.	35	
D	P.L.		120
G	P.L.		90
Cash	C.B.	4	
Bank	C.B.	185	
		£960	£960

[1] It will be noted that this item constitutes an asset, the deposit being returnable.

Detection of Errors. Although the Trial Balance totals may agree, it is only the total arithmetical accuracy of the books that may be said to be correct, though even then perfect accuracy is not assured, for compensating errors may arise, e.g. both the Sales and Purchases figures may be undercast to the extent of £100 each. The types of errors that may remain undetected are as follows—

(1) *Errors of Omission.* The omission of *both* debit *and* credit aspects of a transaction will not affect the agreement of the Trial Balance.

(2) *Errors of Commission.* The posting of £100 to the credit of J. Robson instead of to the credit of J. Dobson will not affect the agreement of the Trial Balance. The total of the extract of Sundry Debtors will not in itself be incorrect, though two of its composite items will be wrong. The entries required to correct an error of this type would (in this case) be as follows—

JOURNAL

			£	£
19..	J. Robson . . . . *Dr.*		100	
	To J. Dobson . . .			100
	Being Transfer of item posted in error.			

(3) *Compensating Errors.* One or more debit errors which happen to equal one or more credit errors will not upset the Trial Balance. Thus, a £90 error in the balance of an Asset account—the balance of £100 having been brought down as £10—and a £10 under-addition in the Purchase Day Book would be compensated by the omission of the corresponding credit in the Sales Ledger for a debit of £100 in the Cash Book.

(4) *Errors of Principle.* The posting of a revenue expense to a Capital Account or *vice versa* will not affect the Trial Balance agreement. It can thus easily be seen that the books might be quite incorrect as far as the true position of the business is concerned and yet the Trial Balance agree. The student must therefore take the greatest care throughout all his studies to distinguish between capital and revenue receipts and payments. In broad outline it may be stated that capital payments are those incurred in acquiring Assets for the purpose of earning income, usually identifiable as assets of a permanent nature, thus increasing the earning capacity of the business or decreasing costs. Revenue payments are those incurred in the ordinary course of business, being necessary for its efficient running. It may be generally stated that capital receipts are moneys received from the sale of assets or by the raising of loans, and revenue receipts are moneys received in return for goods sold or services rendered. (See Chapter VIII.)

A simple example is given here to illustrate such error—X is the owner of £10,000 3½ per cent War Loan and upon receipt of the regular half-yearly dividend of £175 he posts the sum to the credit of the Investment Account, whereas it should go to the credit of Income Account or, as will be seen later, to the Profit and Loss Account.

Though the above types of errors may occur and remain undisclosed in the Trial Balance, those given below will always have the effect of causing a discrepancy in the agreement of the Trial Balance unless by chance the errors collectively eliminate each other. They may be divided broadly into two classes—

(1) Book-keeping errors.
(2) Extraction errors.

Book-keeping errors include the following—

(1) Items posted to the wrong side of an account.

(2) The Discount columns of the Cash Book transferred to the wrong sides of the Discount Account.

(3) Items for which the double entry is not complete. These often occur in the case of small returns, discounts and allowances, which have been entered in the personal accounts and not in the Returns or Discount Account.

(4) Omission to post the totals of one or more of the subsidiary books.

Errors of extraction will include the following—

(1) Omission to extract one or more balances, either debit or credit (particularly the Cash and Bank Balances), or a duplication of an item.

(2) Errors in additions. These are caused more often than not by careless alignment of figures and incorrect carrying forward of additions, (e.g. figure 1 badly aligned would result in a difference of 9, 90, 900 according to actual misplacement).

(3) The confusion of figures, e.g. £1 4s. taken as 1s. 4d.

(4) The extraction of items on the wrong side (causing an error of double the sum of the items).

Illustration. The table shown on page 16 is an example of some of the common errors that are made by students when preparing a Trial Balance.

In practice the different items in the Trial Balance would be earmarked by a reference to their Ledger and folio for the sake of quick verification. In examination work such detail is quite unnecessary.

The aim in an examination paper, furthermore, is to avoid the opening of unnecessary accounts, so that where possible all simple accounts should be "posted" direct to the Trial Balance.

Trial Balance as at 31st January, 19..

		Incorrect		*Correct*	
		Dr.	*Cr.*	*Dr.*	*Cr.*
			£		£
Capital			2,000		2,000
Furniture and Fittings	£520				
Less Depreciation, 10%[1]	52				
		468		520	
Stock, Opening	880				
Stock, Closing[1]	1,020				
		1,900		880	
Drawings		450		450	
Goodwill		500		500	
Sales			7,600		7,600
Purchases		5,100		5,100	
Rent, Rates, etc.		210		210	
Discounts Received		260			260
Discounts Allowed			150	150	
Sales Returns			430	430	
Purchases Returns		490			490
Cash in Hand		20		20	
Cash at Bank		590		590	
Sundry Debtors		2,750		2,750	
Sundry Creditors			1,250		1,250
		£12,738	£11,430	£11,600	£11,600

[1] Neither depreciation nor closing stock would normally be in the books at the time of the Trial Balance.

CHAPTER II

BANK RECONCILIATION STATEMENTS AND PETTY CASH

It very rarely happens in practice that the bank balance as shown by the Cash Book agrees with the balance as shown by the Bank Pass Book. The three factors which contribute to this difference are—

(1) Unpresented cheques.
(2) Uncredited cheques.
(3) Errors and omissions.

(1) **Unpresented Cheques.** These are cheques which have been dispatched to customers in payment of their accounts, but which have not been presented for payment to the payer's bank. According to the circumstances, a period of from one to three days will elapse before the cheque is presented for payment, even assuming that the recipient pays the cheque promptly into his own bank. In effect they are items which are entered on the credit side of the Cash Book, and have not as yet been entered in the Pass Book, so that the latter will show a balance more in the customer's favour than that shown by the Cash Book to the extent of such unpresented cheques, i.e. a larger balance due to the customer or a smaller overdraft.

(2) **Uncredited Cheques.** These may be considered as the reverse of unpresented cheques. As soon as cheques are paid into the bank the Bank column of the Cash Book is debited. The bank, however, may not give credit for these cheques immediately owing to the lateness of the hour or for other reasons, so that the Cash Book will show a balance more in the customer's favour than the Pass Book.

(3) **Errors and Omissions.** An error, either on the part of the customer, or the banker, will obviously create a discrepancy between the two balances; further, at the end of every half-year the bank will enter in the Pass Book sums representing interest (in the event of the account having been overdrawn) and commission, the exact amounts of which are unknown to the customer until such time as he has seen the Pass Book. In addition, receipts or payments against Banker's Orders, and dividends and Bills of Exchange collected or paid by the Bank may not have been entered in the Cash Book. Banks do not normally allow interest on current accounts nowadays, but the account may be credited with interest on a deposit account.

FORM OF THE BANK RECONCILIATION STATEMENT

Subject to these considerations, the balances shown by the Cash Book and the Pass Book should agree. It is usual to draw up a

statement which effects the adjustments necessitated by the unpresented and uncredited cheques. This statement is known as a Bank Reconciliation Statement, and is drawn up on the following lines.

The first requirement, which is of paramount importance, is that the date at which the statement is being drawn up shall always be stated at the head thereof in a clear manner. The balance as shown by the Pass Book is then extracted and used as a starting point. The unpresented cheques are found by checking up the payments side of the Pass Book with the credit side of the Cash Book. All the unticked items in the Cash Book (subject of course to any clerical errors) will be the unpresented cheques. The uncredited cheques will be found in a similar manner. The Pass Book balance will then (*a*) be decreased by the amount of the unpresented cheques, or, in the case of an overdraft, increased by such amount, and (*b*) increased by the amount of the uncredited cheques, or, in the case of an overdraft, decreased by such amount. The figure now obtained (subject to errors) should be the same balance as shown by the Cash Book. If the student should at any time be at a loss as to which balance should be used as a base from which to start, he should remember that the balance as shown by the Cash Book, subject to any errors or omissions arising therein, is the true and correct figure which forms the natural conclusion to the Statement.

Illustration. The following particulars relate to the business of A at 31st December—

		£
Balance as shown by the Cash Book	*Dr.*	1,000
Balance as shown by the Bank Pass Book . .	*Dr.*[1]	1,200
Unpresented Cheques		300
Uncredited Cheques		100

BANK RECONCILIATION STATEMENT AT 31ST DECEMBER, 19..

		£
Balance as per Pass Book	*Dr.*	1,200
Add Uncredited Cheques (detailed)		100
		1,300
Less Unpresented Cheques (detailed) . . .		300
Balance as per Cash Book . .	*Dr.*	£1,000

Many questions are set in which, in addition to particulars as to unpresented and uncredited cheques, the candidate is informed that there are various clerical errors in the Cash Book, e.g. incorrect

[1] It is assumed that the Pass Book is headed "Bank in account with A," but in the accounting books of the bank the amount of £1,200 will actually be in credit, in which form Pass Books are often written up, the heading then being "Customer in account with Bank."

figures, entries on incorrect sides or in wrong columns, omissions, etc. When dealing with a question of this type the true Cash Book balance should always be ascertained separately, and the Reconciliation Statement prepared from the Pass Book balance.

For examination purposes, however, it is permissible to prepare one Statement only, in which event it is imperative to point out to the examiner that this procedure has been adopted to economize time—a very formidable factor in the professional Accountants' examinations—and, in addition, to indicate briefly that the bank balance will require adjusting in the financial books, and that only when so adjusted, will it represent the true position. However, if the Pass Book shows a sum of £100 in favour of the customer, but according to the latter's Cash Book there is an overdraft of £20 (the difference arising by reason of a cheque of £120 having been sent to a Creditor and entered accordingly), it would clearly be inaccurate and dangerous to adjust the Cash Book figure to that shown by the Bank. The Cash Book figure, subject to errors and omissions, always shows the real position.

Where the unpresented and uncredited cheques are not given, it is necessary to see the Pass Book subsequent to the close of the period and deduce the information by noting each of the subsequent entries in the Pass Book that have been entered in the Cash Book in the period under review.

Illustration.

Dr. BANK COLUMNS OF CASH BOOK (OF X) *Cr.*

19..			£	19..			£
Dec. 4	To Balance	b/d	38	Dec. 3	By Drawings		20
8	,, Walters & Co.		42	10	,, F. Murray		119
17	,, Drummond Bros.		100	17	,, Cheque Book		1
22	,, F. Scarfe		131	21	,, Carlill & Co.		52
30	,, McEuen & Co.		30	30	,, Howe & Co.		38
31	,, Garners, Ltd.		18	31	,, G. Atkinson		11
					,, Commission		1
					,, Wages and Salaries		40
					,, Balance	c/d	77
			£359				£359
19.. Jan. 1	To Balance	b/d	77				

BANK PASS BOOK

Dr. (Bank in account with X) *Cr.*

19..			£	19..		£
Jan. 1	To Balance	b/d	92	Jan. 2	By Carlill & Co.	(c) 52
3	,, McEuen & Co.		(a) 30	4	,, W. Herring, Ltd.	4
4	,, C. McLeod		7	6	,, McEuen & Co., Cheque Dishonoured	30
5	,, Garners, Ltd.		(b) 18	7	,, D. Hickman & Co.	35
8	,, G. Daw		49	8	,, G. Atkinson	(d) 11

Prepare Bank Reconciliation Statement at December 31st, 19..

It is clear that items (*a*) and (*b*) refer to the preceding period on the one side, and (*c*) and (*d*) on the other. Hence the other items refer exclusively to the following year. Thus, the uncredited cheques are (eliminating names) £30 and £18, the unpresented cheques £52 and £11.

The statement is therefore—

BANK RECONCILIATION STATEMENT AT 31ST DECEMBER, 19..

			£
Balance as per Pass Book	*Dr.*		92
Less Unpresented Cheques		£52	
		11	
		—	63
			29
Add Uncredited Cheques		£30	
		18	
		—	48
Balance as per Cash Book	*Dr.*		£77

It will be observed that McEuen's cheque of £30 is dishonoured. This may be dealt with as if the cheque had not been paid in, seeing that it has really never been paid, so that it will be necessary to credit the Bank column of the Cash Book with £30, thus reducing the balance thereon from £77 to £47. (The amount will be debited to McEuen, and thence, if the facts warrant it, to Bad Debts Account.) The Reconciliation Statement will now be—

		£
As above		29
Add Uncredited Cheque		18
Balance as per Cash Book	*Dr.*	£47

The Cash Book, as adjusted, will be thus—

Dr. BANK COLUMNS, CASH BOOK (OF X) *Cr.*

19..			£	19..			£
Dec. 31	To Balance	b/d	77	Dec 31	By McEuen & Co, Dishonoured Cheque		30
					,, Balance	c/d	47
			£77				£77
19.. Jan. 1	To Balance	b/d	47				

The debit and credit items in the Pass Book appearing in the next year (in reference to McEuen) merely cancel themselves.

On the other hand, the non-payment may be considered as relating to the next year, so that the original Reconciliation Statement

and the cash balance remain, and the credit entry in the Cash Book will be made in the following year to agree with that made in the Pass Book. If this procedure is adopted, the Reconciliation Statement is entirely unaffected. Should it be desired to make provision for the possibility of the debt being bad, a Reserve may be made in the books. It is submitted that the former method is the more prudent, as it eliminates £30, which cannot be relied upon as being cash in bank.

Illustration. The entries of bank transactions effected by A during the half-years to 30th June, and to 31st December, 19. ., are shown, omitting names, as recorded in the Bank Pass Book and in the Cash Book of A for those periods. It is required to prepare Bank Reconciliation Statements at those dates.

Pass Book entries—

Dr. A IN ACCOUNT WITH THE X Y Z BANK *Cr.*

19..			£	19..			£
			71	Jan 1	By Balance	b/d	272
			32				35
			38				75
			17				111
			14				23
June 30	To Commission		1				
	,, Balance	c/d	345	June 30	,, Interest on Deposit		2
			£518				£518
			23	July 1	By Balance	b/d	345
			35				20
			16				84
			19				32
			24				4
			17				44
			3				100
			852				30
Dec. 31	To Commission		1				15
	,, Balance	c/d	281	Dec 31	,, Interest on Deposit		3
			£677				£677
19.. Jan. 1			19	19.. Jan. 1	By Balance	b/d	281
							75

[It may be mentioned that many banks, by the adoption of mechanical posting machines, are able to show the resultant balance of a customer's account after each transaction, in which case the above account would be shown as follows—

A IN ACCOUNT WITH THE X Y Z BANK

Date		Date	Details	Debit	Details	Credit	Balance	Credit* Overdrawn O.D.
19.. Jan. 1	Old Balance		Forward		Forward			272*
						35		307*
				71				236*

The account would be continued on these lines, the resultant balance being disclosed after each transaction.]

Cash Book entries—

A

Dr. CASH BOOK (BANK COLUMNS ONLY) **Cr.**

19.. Jan. 1	To Balance	b/d	£ 272	19..	By Sundries		£ 71
	,, Sundries		35				38
			75				(c) 23
			111				17
			23				14
			20				16
							24
							(b) 23
				June 30	,, Balance	c/d	310
			£536				£536
July 1	To Balance	b/d	310		By Corrected Error		(c) 9
	,, Bank Interest		(a) 2		,, Bank Commission		(a) 1
			84				35
			32				19
			4				19
			100				3
			44				17
			75				258
				Dec. 31	,, Balance	c/d	290
			£651				£651
Dec. 31	To Balance	b/d	290	Dec. 31	By Bank Commission		(d) 1
			(e) 15		,, Balance	c/d	337
			(f) 30				
	,, Bank Interest		(d) 3				
			£338				£338
19.. Jan. 1	To Balance	b/d	337				

(1) Bank Reconciliation at 30th June, 19..—

(*a*) Bank interest and commission have not been entered in the Cash Book.

(*b*) Cheque for £23 returned from the bank for endorsement by customer not entered in the Pass Book.

(*c*) Item entered in Cash Book in error as £23 vice £32.

CASH BOOK ADJUSTMENT

		£
Balance as per Cash Book		*Dr.* 310
Less Bank Commission	£1	
Error adjusted	9	
		10
		300
Add Bank Interest		2
Adjusted Balance as per Cash Book		*Dr.* £302

BANK RECONCILIATION STATEMENT AS AT 30TH JUNE, 19..

			£
Balance as per Pass Book	Dr.		345
Less Unpresented Cheques		£24	
		16	
			40
			305
Returned Cheque unentered			23
			282
Add Uncredited Cheque			20
Balance as per Cash Book (adjusted)	Dr.		£302

It will be noticed that all these matters requiring adjustment automatically smooth themselves out in the entries of the succeeding half-year to 31st December, e.g. the returned cheque £23 is debited up to the customer by the bank. The Pass Book is here shown in the form: "A in Account with the XYZ Bank" and not "The XYZ Bank in Account with A" and so the transactions are shown from the point of view of the bank—it is in fact a replica of the customer's account in the ledger of the bank.

(2) Bank Reconciliation at 31st December, 19..—

(*d*) Bank interest and commission not entered in the Cash Book.

(*e*) Item of \$42 dividend paid direct to bank—notified credited at \$2·80 to the £—not in Cash Book.

(*f*) Item of £30 paid in at another branch—not entered as yet in Cash Book.

CASH BOOK ADJUSTMENT

			£
Balance as per Cash Book	Dr.		290
Add Bank Interest		£3	
Dividend unentered		15	
Cheque unentered		30	
			48
			338
Less Bank Commission			1
Adjusted Balance as per Cash Book	Dr.		£337

It is immaterial whether additions precede deductions or, as in the Cash Book adjustment on page 22, the deductions precede the additions.

BANK RECONCILIATION STATEMENT AS AT 31ST DECEMBER, 19..

		£
Balance as per Pass Book	Dr.	281
Less Unpresented Cheque		19
		262
Add Uncredited Cheque		75
Balance as per Cash Book (adjusted)	Dr.	£337

It will again be noted that the items calling for adjustment are righted in the subsequent period.

PETTY CASH BOOK

In all large businesses there are numerous small expenses to be met by cash payments. If all these payments were entered in detail in the main Cash Book, which is usually written up by a senior official, much valuable time would be wasted. To obviate this, a separate Cash Book, termed a Petty Cash Book, is utilized, in which all these expenses are recorded.

The conventional system for recording petty cash is known as the Imprest System, the main features of which are as follows. At the start of each accounting period the petty cashier is supplied with a round sum in cash, often termed a "float." This amount should be sufficient to cover the estimated petty cash expenditure for a stated period, e.g. a week or a month. At the end of this period the petty cashier must ascertain the total amount spent, and he will be reimbursed out of the General Cash Book for such amount, the balance in hand being thus restored to the original starting figure. Hence opportunity for the accumulation of large sums of cash in the hands of the petty cashier is eliminated and the risk of fraud minimized, as a complete check on the petty cashier may be kept at all times, since the sum of the vouchers representing money spent plus the cash in hand should always equal the amount of the "float."

When this system is adopted the initial advance to the petty cashier is debited to Petty Cash Account in the ledger, and cash is credited. At the same time the amount is debited for practical purposes (this is a memorandum entry, the double entry having already been completed) in the Petty Cash Book. When the expenditure for the period is recouped, the petty cashier's balance is restored to the original figure. The entries in the double-entry books will be as follows—

Dr. Expenses (per the detailed analysis of the Petty Cash Book).
Cr. Cash (with details) in the General Cash Book.

All moneys paid out of petty cash are entered on the credit side of the Petty Cash Book, and extended into analysis columns, the totals of which are utilized for posting at suitable periods to the debit of the appropriate nominal accounts from the General Cash Book. It often happens in practice that Ledger accounts are settled through the Petty Cash. In such cases a special column must be opened in respect of Ledger accounts, and the amounts paid to creditors must be inserted therein and posted to the debit of the respective accounts in the Ledger. The total of the Ledger column will not be posted to any account since the items contained therein will have been posted individually to their separate accounts.

Illustration. A. & Co., who keep their Petty Cash on the Imprest System, and maintain a weekly floating balance of £20, have the following transactions for the week ending 27th January—

			£	s.	d.
19..					
Jan.	22.	Postages	4	10	0
		H. C. Smith (who has an account in the Creditors' Ledger)	3	4	6
	23.	Office Table	2	10	0
	24.	Tram Fares		1	0
	25.	Tip to Carter			6
	26.	Carriage		4	5
	27.	Casual Labour (Wages)	1	5	0
		Notepaper		10	0

The Petty Cash Book will be as follows—

Dr. PETTY CASH BOOK

		Folio	£ s. d.			Voucher No.	Total £ s. d.
19.. Jan. 22	To Cash		20 0 0	19.. Jan. 22	By Postages .		4 10 0
					,, H. C. Smith .		3 4 6
				23	,, Table . .		2 10 0
				24	,, Fares . .		1 0
				25	,, Tip to Carter .		6
				26	,, Carriage . .		4 5
				27	,, Casual Labour .		1 5 0
					,, Notepaper .		10 0
							12 5 5
					,, Balance . .	c/d	7 14 7
		£	20 0 0			£	20 0 0
Jan. 29	To Balance	b/d	7 14 7				
	,, Cash .		12 5 5				

Cr.

Postages £ s. d.	Stationery £ s. d.	Carriage £ s. d.	Furniture £ s. d.	Wages £ s. d.	Sundries £ s. d.	Led. Fol.	Ledger Account £ s. d.
4 10 0							
						20	3 4 6
			2 10 0				
					1 0		
		6					
		4 5					
				1 5 0			
	10 0						
£4 10 0	10 0	4 11	£2 10 0	£1 5 0	1 0		£3 4 6
Fol.	Fol.	Fol.	Fol.	Fol.	Fol.		

Nominals

The £20 on 22nd January will have come from the Cash Book and the debit entry will be made therefor to the debit of Petty Cash Account in the Ledger representing the amount expended. At 27th January the Cashier will hand cash amounting to £12 5s. 5d. to the petty cashier. The double-entry will be—

	£ s. d.	£ s. d.	£ s. d.
Dr. Postages	4 10 0		
Stationery . . .	10 0		
Carriage	4 11		
Furniture	2 10 0		
Wages	1 5 0		
Sundries	1 0		
Ledger Account (Smith) .	3 4 6		
		12 5 5	
Cr. Cash (detailed similarly) .			12 5 5

In this way the Petty Cash Book merely acts by way of memorandum and provides the necessary data for the double-entry.

Alternative Methods. Alternatively, the Petty Cash Book could be used as a double-entry book, in which case the double-entry would be provided thus—

(1) Dr. Petty Cash Account in Petty Cash Book.
Cr. Cash (in General Cash Book).

(2) When the Cash spent is recouped.
Dr. Petty Cash Account in Petty Cash Book.
Cr. Cash (in General Cash Book).

(3) Dr. Expenses (detailed).
Cr. Petty Cash Account in Petty Cash Book.

In this case the Petty Cash Book is regarded as an account just as the General Cash Book and is definitely an integral part of the double-entry.

As a further alternative the cash recoupment may be posted in one sum from the Cash Book to the Petty Cash Account in the Ledger, and from there the different amounts will be credited out to the Expenses Accounts, leaving eventually the same balance on Petty Cash Account as before.

There may be cases to which the Imprest System is not suited, as when sudden large balances of cash are necessary, or when there are only very occasional calls for petty cash expense, which are met by the cashier as they arise.

It should be observed that two of the systems described in connection with the Imprest System can be utilized also in a slightly modified form where no imprest system is enforced.

(*a*) **Where the Petty Cash Book is Part of the Double-entry System.** Periodical sums paid to the petty cashier will be debited to the Petty Cash Book and credited to the General Cash Book. The Petty Cash Book will be ruled in columnar form or will be analysed at the

end of periods by other means, the totals of the columns or the analysed amounts being posted at suitable periods from the Petty Cash Book to the debit of Expenses Accounts.

(*b*) **Where the Petty Cash Book is a Memorandum Book only.** A Petty Cash Account in the Ledger will be opened, thus supplying the integral link with the main accounting system.

Periodical sums paid to the petty cashier will be debited (1) to the Petty Cash Account and (2) (for memorandum purposes) to the Petty Cash Book. The Petty Cash Book will be analysed under different headings as above, and these items will be credited to the Petty Cash Account and debited to the various Expenses Accounts. It is important to notice, in this method, that the postings to the Expenses Accounts are made from the Petty Cash Account and not from the Petty Cash Book. In view of this fact it is desirable to make a Journal entry which will show concisely at a glance the details of the transfers recorded.

Illustration. The following payments were made to the Petty Cashier during the month of December, 19..—

19..		£
Dec. 4.	Cash	5
18.	Cash	6
24.	Cash	2

The balance on hand on 1st December, 19.., was £2 1s. 7d.

The Petty Cash Book was written up by the petty cashier, and the details appear in the subjoined account.

The above book, as stated previously, may be memorandum only, in which case the double-entry will be compiled by having a Petty Cash Account in the Ledger, as follows—

Dr. PETTY CASH *Cr.*

19..			£	s	d	19..			£	s.	d.
Dec 1	To Balance .	b/d	2	1	7	Dec. 31	By Expenses as per Petty Cash Book (*a*)—				
31	„ Cash .	.	13	0	0		Postages .		3	0	0
							Cleaning .		3	5	0
							Sundries .		4	2	1
							Carriage .		1	7	5
							„ Balance .	c/d	3	7	1
		£	15	1	7			£	15	1	7
19..											
Jan 1	To Balance .	b/d	3	7	1						

(*a*) These expenses will be posted to the debit of the appropriate Ledger Accounts, the details of which will appear in the Petty Cash Book.

CHAPTER III

ARITHMETIC OF ACCOUNTANCY

THE author has learnt, from long experience gained in coaching, that one of the contributory causes of failure in examinations is the lack of ability to compute commonplace arithmetical calculations quickly and accurately. The capacity to recognize at sight a simple arithmetical point should also be developed by accountancy students. In this chapter, therefore, an attempt is made to deal with the calculations which are frequently required in working out problems set in the modern accountancy examinations, and which, simple though they be, cause endless confusion and uncertainty in the minds of students.

A great deal of time—a factor of utmost importance in examinations—can be saved by working out calculations in a systematic manner. The average student will have many opportunities in the course of his everyday work of putting into practice a multitude of simple time-saving arithmetical devices, of which the following are examples—(*a*) dividing twice by two when dividing by four. (*b*) Multiplying by two and dividing by ten when dividing by five. (*c*) Simple interest calculations may be considerably facilitated at times by the application of the following rules, viz.—

5% per annum Simple Interest is					one penny on £1 per month.
6%	,,	,,	,,	,,	one shilling on £10 per month.
4%	,,	,,	,,	,,	1% per quarter.

Illustration.

5% per annum on £129 for 7 months
= 7 × 10s. 9d. = £3 15s. 3d.
4% per annum on £285 for 3 months
= 1% of £285 = £2 17s.

The student is generally inclined to note these simple devices with mild interest and subsequently to banish them entirely from his mind, but it is essential that he should endeavour to cultivate these "short cut" arithmetic habits until they become spontaneous. As a result when the examination time arrives he will find himself armed with a most useful battery of time-saving weapons against the examinee's chief adversary "lack of time." Again the student must learn the use of simple algebra, which is called for particularly in the more difficult problems, examples of which will be found in the chapters on Partnership and Limited Companies. It must be realized

that a fundamental knowledge of simple algebra is absolutely essential for the modern examinations, and it is only by constant practice that proficiency may be attained. Though the problems in this book calling for algebraic solution may be passed over at a first reading, they must eventually be faced and mastered, so that algebra may be called to hand with complete confidence, and without the fear of unfamiliarity and uncertainty, in the examination hall.

COST AND SELLING PRICE

Many problems are set in which either the selling price or the cost price of a certain line of goods is given, together with the rate of gross profit earned, this rate of gross profit to be computed on either the cost price or the selling price, according to which is the unknown figure. If the selling price is given, the student may be required to find the cost price, and *vice versa*. This type of problem is met with very frequently in examinations, especially in questions on Cost Accounts.

Great care must be taken to see on which price the rate of gross profit is based.

Illustration. The gross profit is 25 per cent on cost; the selling price is £175. It is required to find the cost price. This may be obtained as follows—

		£
Let the cost price	=	100
The profit is 25% thereof	=	25
∴ When the cost price is £100 the selling price	=	125
∴ When the selling price is £175 the cost price	=	$\frac{100}{125} \times 175$
	=	£140

In the above illustration the percentage of gross profit or "Loading" on COST is given and the Selling price is the known figure. The terms may be interchanged, i.e. the percentage of Gross Profit or "Loading" on SELLING price may be given and the COST price be the known figure. It will be noted, for example, that the percentage of Gross Profit on Selling price is 20 per cent, whilst the percentage on Cost price is 25 per cent.

As an illustration of the interchangeability of the percentage expressions the following may be appended—

20% of Cost	=	16⅔% of Selling, or	$\frac{1}{5}$	of Cost	=	$\frac{1}{6}$	of Selling.
25% ,,	=	20% ,,	$\frac{1}{4}$	,,	=	$\frac{1}{5}$	,,
33⅓% ,,	=	25% ,,	$\frac{1}{3}$	,,	=	$\frac{1}{4}$	,,

Similarly

$$\tfrac{2}{5} \text{ of Cost} = \tfrac{2}{7} \text{ of Selling, i.e. } \frac{2}{5+2} \text{ of Selling.}$$

$$\tfrac{3}{11} \quad " \quad = \tfrac{3}{14} \quad " \quad \text{i.e. } \frac{3}{11+3} \quad "$$

$$\tfrac{7}{19} \quad " \quad = \tfrac{7}{26} \quad " \quad \text{i.e. } \frac{7}{19+7} \quad "$$

It should be appreciated that, once proficiency in making this conversion has been attained, valuable time will be saved in examination work. If a percentage of profit on Sales and the Cost figure are given in a question, by the process of conversion the required figure can usually be obtained mentally, e.g. a profit of $\frac{2}{13}$ is made on Sales, and the Cost is £1,650. What are the Sales? The student will immediately think of the known factor, i.e. Cost, and secondly he will convert the $\frac{2}{13}$ profit on Sales into $\frac{2}{11}$ profit on Cost (the known factor).

Profit = $\frac{2}{11}$ × £1,650 = £300
∴ Sales = £1,650 (cost) + £300 (profit) = £1,950

The profit thereon is £300, which is $\frac{2}{13}$ of Sales.

ALIQUOT PARTS

Where a certain amount has to be subdivided into smaller parts which themselves must be maintained in a certain ratio, students are often at a loss as to how the whole is to be divided at each subdivision. The rule is to take the total of all the ratios and divide it into each ratio; this will give the fraction of the whole represented by each share.

Illustration. A, B, C, and D, are to divide £1,000 in the ratio of 4 : 3 : 2 : 1. How much does each receive?

4 + 3 + 2 + 1 = 10
∴ A will receive $\frac{4}{10}$ × £1,000 = £400
∴ B " " $\frac{3}{10}$ × £1,000 = £300
∴ C " " $\frac{2}{10}$ × £1,000 = £200
∴ D " " $\frac{1}{10}$ × £1,000 = £100
£1,000

Should at any time one or more of the dividing parties drop out and the remainder still wish to maintain as between themselves the same *ratio* as before, all that is required is to proceed as before, ignoring the share of any party who has dropped out.

Illustration. Assume that in the previous example B drops out; the ratios will then be A : C : D in the ratio of 4 : 2 : 1.

4 + 2 + 1 = 7
∴ A will receive $\frac{4}{7}$ × £1,000 = £571$\frac{3}{7}$
∴ C " " $\frac{2}{7}$ × £1,000 = £285$\frac{5}{7}$
∴ D " " $\frac{1}{7}$ × £1,000 = £142$\frac{6}{7}$
£1,000

The same principles exactly are involved in many instances which occur in business of a sum being received before it is earned, e.g. in hire purchase contracts, and discounting of bills of exchange. In these cases it is necessary to transfer a portion only to Profit and Loss Account in the first year.

An excellent illustration arises in hire purchase transactions when a Hire Purchase Reserve is created and transferred to Profit and Loss Account in fixed instalments over the period of the agreement. The matter will be treated in detail in its appropriate place and the sole point of its introduction at this stage is to deal with the arithmetical side.

Illustration. X deals with goods on Hire Purchase and creates a Reserve to cover risk, interest, etc., which is added to the price to the customer. The amount in four years is £1,000 and it is to be transferred to Profit and Loss Account over four years as follows—(1) 15 per cent, (2) 45 per cent, (3) 30 per cent, and (4) 10 per cent. Thus the amounts to be written off in the respective years will be $\frac{15}{100}$, $\frac{45}{100}$, $\frac{30}{100}$, and $\frac{10}{100}$ of £1,000, i.e. £150, £450, £300 and £100. The question thus presented is simple enough, but it is sometimes presented in a form that causes difficulty.

Illustration. Using the same data the question states that at the end of the second year the balance of the Reserve is £400 (i.e. £150 and £450 have been transferred to Profit and Loss Account). The amounts remaining to be transferred to Profit and Loss Account are to be calculated on the written down figure of the Reserve £400. If the beginning figure is not given, but merely the written down figure of the Reserve (£400), and the percentages transferred or to be transferred in each of the four years, the proportions to be written off in the third and fourth year may be obtained similarly, viz.—

3rd year	$\frac{30}{40} \times$ £400 = £300
4th year	$\frac{10}{40} \times$ £400 = £100

The point to watch is that in the third and fourth year the calculation is based upon the REMAINING Reserve, and not on the original, so that the proportions transferred must likewise be based on the remaining proportions.

Thus, if the Reserve had been given as at the beginning of the second year, i.e. £1,000 − 150 = £850, the proportions to be written off in the three succeeding years would have been 45, 30, 10, i.e.—

2nd year	$\frac{45}{85} \times$ £850 = £450
3rd year	$\frac{30}{85} \times$ £850 = £300
4th year	$\frac{10}{85} \times$ £850 = £100

COMMISSION

In many questions it is stated that the manager is to receive a commission of a certain percentage of the profits *after* deduction of

this commission and only the trading profits figure is given (i.e. profits before deduction of the commission) and it is required to find the amounts due to the manager under this head.

Illustration. A is to get 10 per cent of the profits of A. B. Ltd., after deducting his commission. Profits prior to charging commission are £2,200.

> **If A gets £100 commission**
> **The *remaining* profits = £1,000**
> **∴ Total profits = £1,100**
> **∴ Commission = $\frac{1}{11}$ of the total profits**
> **∴ If the total profits are £2,200, the commission**
> **= $\frac{1}{11}$ × £2,200 = £200**

Hence A's commission is one-eleventh of the profits ***prior*** to charging the commission and one-tenth of the profits ***after*** charging the commission.

Similarly, if the commission is 5 per cent ($\frac{5}{100}$) of profits after charging the commission, the calculation would be $\frac{5}{105}$ × profits before charging commission; if 8 per cent, then $\frac{8}{108}$ × profits before charging commission; if 20 per cent, then $\frac{20}{120}$ × profits before charging commission.

Where the commission on profits prior to charging commission is stated in the form of a vulgar fraction, into which form a percentage may easily be changed, viz—8 per cent $\frac{8}{100}$, 15 per cent $\frac{15}{100}$, etc., the rule is to increase the denominator by the amount of the numerator, and the resultant fraction multiplied by profits PRIOR to charging the commission produces the required commission figure.

Illustration. A is to get $\frac{2}{45}$ of the profits of A. B. Ltd., after charging his commission. Profits prior to charging his commission are £9,400.

$$\text{Commission} = \frac{2}{45+2} = \frac{2}{47} \times \text{profits prior to charging commission}$$

$$\frac{2}{47} \times 9{,}400 = £400 \quad \left[\text{or } \frac{2}{45}(9{,}400 - 400) = £400\right]$$

The same type of problem arises as below—

In bankruptcy it frequently happens that the trustee is entitled to a remuneration based upon dividends paid to unsecured creditors. After all the other expenses have been paid, the cash left will provide both for the remuneration of the trustee and for the dividend to the unsecured creditors, and the remuneration will be a percentage based, not upon the total cash remaining, but upon that paid to the unsecured creditors.

Illustration. A trustee in bankruptcy is entitled to 2½ per cent commission on the dividend paid to unsecured creditors: the cash available, subject to the above, is £3,280, and the unsecured creditors amount to £6,400.

The remuneration of the trustee will be $\frac{2\frac{1}{2}}{102\frac{1}{2}} = \frac{1}{41} \times £3{,}280 = £80$, leaving £3,200 for the unsecured creditors. The remuneration is thus 2½ per cent of £3,200.

Care should be taken in the case where the resultant figure is *already* ascertained, as the computation will be simply 2½ per cent upon the ascertained figure.

Illustration. Assuming that £6,800 cash was available in the above illustration, then, as the creditors can receive no more than £6,400 (i.e. 20s. in the £), the dividend is already ascertained, and the remuneration of the trustee will simply be 2½ per cent of £6,400, i.e. £160. (The balance left will be handed over to the Debtor.)

DECIMALIZING £ s. d.

Wherever possible, in dealing with fractions of £ s. d. the decimal system should be used. From the formula given below any sum of money can be instantly decimalized or turned from decimals into £ s. d. It is only with practice, however, that great rapidity and accuracy can be obtained, and every student is advised to spend some time working out examples for himself.

To decimalize money—

			£
Every	2s.	=	·1
,,	1s.	=	·05
,,	¼d.	=	·001 (approx.)

(*a* When the pence are less than 3d. every ¼d. should be taken as £·001.

(*b*) Where the pence are 3d. or over, but less than 9d., every ¼d. should be taken as £·001 and ·001 added to the result.

(*c*) Where the pence are 9d. or over, every ¼d. should be taken as £·001, and ·002 added to the result.

Illustration.

£	s.	d.		£	£	s.	d.		£
100	4	2	=	100·208	6	14	8	=	6·733
98	5	3	=	98·263	109	12	9	=	109·638
7	19	6½	=	7·977		18	11¼	=	·947

For changing back decimals into shillings and pence the familiar method of multiplying first by twenty, and secondly by twelve, is generally employed. However, greater celerity may be achieved—indeed the calculation may always be computed mentally and rapidly—if the methods outlined above for decimalizing money are reversed, thus—

(*a*) Where the decimal exceeding ·05 is ·013 or over, deduct ·001 and divide the remainder by four to find the pence.

(*b*) When the decimal exceeding ·05 is ·038 or over, deduct ·002 and divide the remainder by four, to find the pence.

The shillings may be ascertained at a glance, each ·05 representing one shilling.

Illustration.

£		£	s.	d.	£		£	s.	d.
5·223	=	5	4	5½	12·879	=	12	17	7
27·042	=	27	0	10	2·098	=	2	1	11½

STOCKS AND SHARES

The majority of students will have learnt, at some time in their studies, the arithmetic of stocks and shares, but the author has found that the following types of problems involve even advanced students in difficulties.

(1) Where the rates of interest paid and the required yield are given, and it is required to find the market price of securities, the calculation is as follows—

$$\text{Market price} = \text{Nominal value} \times \frac{\text{Actual rate of Interest paid}}{\text{Required yield}}$$

Illustration. At a certain date the market considers 4 per cent per annum to be a fair return on 3½ per cent Conversion Loan. Accordingly the market price will be—

$$£100 \times \frac{3\frac{1}{2}}{4} = £87 \text{ 10s. per } £100 \text{ Nominal}$$

(2) When the amount of money invested is given together with the market price of the investment, the nominal amount purchased is found as follows—

$$\text{Nominal amount} = \frac{\text{Amount invested}}{\text{Market price}}$$

Illustration. A invests £1,000 in buying £1 shares in X. V. Ltd., paying 50s. per share. The nominal amount of his holding is therefore—

$$£\frac{1{,}000}{2\frac{1}{2}} = £400$$

(3) Where the market price of the investment is so much per hundred (i.e. Stock) the formula is—

$$\text{Nominal amount} = \frac{\text{Amount invested}}{\text{Market price}} \times 100$$

Illustration. A invests £1,000 in 3½ per cent Stock at 80. The nominal amount of his holding is therefore—

$$£\frac{1{,}000}{80} \times 100 = £1{,}250$$

(4) When the cost of the investment, the market price and the rate of interest are given, the gross amount of the dividend (or interest) can rapidly be obtained without ascertaining the nominal amount of the investment from the formula (where the investment is quoted per £100)—

$$\text{Interest} = \frac{\text{Amount Invested} \times \text{Rate of Interest}}{\text{Market price}} \times 100$$

Illustration. A invests £2,400 in $3\frac{1}{2}$ per cent Stock at 84. The interest for a full year is therefore—

$$£\frac{2400 \times 3\frac{1}{2}}{84} = £100$$

Proof. The Nominal amount of the Stock will be—

$$£\frac{2{,}400 \times 100}{84} = £\frac{20{,}000}{7}$$

$$3\tfrac{1}{2}\% \text{ per annum for one year on } £\frac{20{,}000}{7} = £\frac{20{,}000}{7} \times \frac{7}{200} = £100$$

The above formula is true only where the investment is stated as so much per hundred. Otherwise the nominal amount of the investment will be found simply by dividing the amount invested by the market price, as shown above. The gross amount of the interest may then easily be calculated.

(5) Where the risk involved in a certain investment is given together with the estimated cash amount of the dividend, and it is required to find the market price—

$$\text{Market price} = \frac{\text{Amount of the dividend}}{\text{Percentage of risk}} \times 100$$

Illustration. The shares of no par value of the Yankee Bank Inc. are considered to involve a risk of 7 per cent, and the next dividend is estimated to amount to \$10.50 per share. (As the shares are of no par value, the dividend cannot be expressed in terms of a percentage.)

The price of each share will therefore be—

$$\$\frac{10.50 \times 100}{7} = \$150.00$$

Proof. Price of each share = \$150.00. Risk 7 per cent per annum.

Dividend—\$10.50 per share *and* 7 per cent of \$150.00 = \$10.50 dividend.

In all questions of the above type, no candidate can expect to earn full marks unless he deals with the question of the amount of dividend earned to date included in the price.

In all cases the amount of any dividend accrued will have to be added to the price found by the formula to get the actual market price.

The following example illustrates the working of a problem in which it is necessary to find the proceeds of an original investment which has been converted into another.

Illustration. A expends £1,000 on 5 per cent Stock at 95 which he sells at 105, investing the proceeds in $3\frac{1}{2}$ per cent Stock at 70, and sells at 68. How much does he receive on sale?

The amount purchased of 5% Stock $= £1{,}000 \times \frac{100}{95}$, i.e. Nominal $= x$

which when he sells produces $x \times \frac{105}{100} = y$

with the amount of y, he is able to make a purchase of $3\frac{1}{2}$% Stock $y \times \frac{100}{70} = z$

which when he sells produces $z \times \frac{68}{100} = ?$

This will equal

$$£1{,}000 \times \frac{100}{95} \times \frac{105}{100} \times \frac{100}{70} \times \frac{68}{100}$$

It will be seen that the four "100's" cancel, leaving the calculation as follows—

$$1{,}000 \times \frac{105}{95} \times \frac{68}{70} = 1{,}000 \times \frac{21}{19} \times \frac{68}{70} = 100 \times \frac{21}{19} \times \frac{68}{7} \quad \frac{100 \times 3 \times 68}{19}$$

$$\text{i.e. } £\frac{20{,}400}{19} = £1{,}073\ 13s.\ 8d.$$

It is, therefore, simpler to employ the rule of dividing the original sum by the purchase price (in the above example, 95), then multiplying such result by the selling price (in the above example, 105) and so on till the final sale is reached.

Illustration. A expends £2,000 on a purchase of 4 per cent Stock at 75, which he sells for 72, and with the proceeds he buys 5 per cent Stock at 96, selling the latter at 100. The amount finally realized

$$= \frac{2{,}000}{75} \times \frac{72}{1} \times \frac{1}{96} \times \frac{100}{1}$$

$$= 2{,}000 \times \frac{72}{75} \times \frac{100}{96} = 2{,}000 \times \frac{3}{75} \times \frac{100}{4}.$$

$$= £2{,}000$$

Actually the answer is obtainable at sight, because in the first instance he loses $\frac{3}{75}$ and in the second he gains $\frac{4}{100}$, i.e. in one case he loses $\frac{1}{25}$ and in the second he gains $\frac{1}{25}$.

FLAT AND REDEMPTION YIELD

(*a*) The flat yield is the yearly return on an investment, ignoring any profit or loss accruing on redemption, e.g. a stock may be issued at 98 redeemable in 10 years' time at 108, thus giving a profit to the holder, so that—

(*b*) The redemption yield is the yearly return on the investment

taking into account any profit or loss on redemption, i.e the flat yield plus yearly profit arising from surplus of redeemable price over purchase or issue price; or the flat yield less yearly loss resulting from deficiency of redeemable price as regards purchase or issue price.

Illustration. A buys at the date of issue 5 per cent Stock at 95 redeemable in 10 years' time at 105. Ignore expenses.

Flat yield

$$\frac{5}{95} \times 100 \qquad = 5{\cdot}26\% \text{ per annum}$$

Profit on redemption

$$= \frac{10}{95} \times 100$$

$$= \frac{\frac{10}{95} \times 100}{10} \text{ yearly}$$

$$= \frac{1}{95} \times 100 \qquad = 1{\cdot}05\% \text{ per annum}$$

$$\text{Redemption yield} \qquad = 6{\cdot}31\% \text{ per annum}$$

It is clear that the holder gains 10 points in 10 years on every £100 of Stock, so that on an outlay of £95 he receives (or strictly his capital is augmented by) £1 each year, i.e. $\frac{1}{95} \times 100$ per cent yield per annum.

The same principle will apply in case of a loss on redemption; for instance if the redemption price at the end of 10 years is 85 then there will be a loss of $\frac{10}{95}$ in ten years, which calculated exactly as above, equals 1·05 per cent per annum.

Therefore the yield per annum on the Stock, taking into account loss on redemption, is

Flat yield	= 5·26% per annum
Loss on redemption	= 1·05% per annum
Net yield	= 4·21% per annum

In practice two very important details will affect the results, viz.—

(1) Cost of purchase or sale (not applicable in the above illustration as the circumstances postulate an application for the Stock on issue and the retention of the Stock till maturity).

(2) Income Tax.

The above-mentioned method, so far as ordinary requirements are concerned, is invariably adopted in practice, although theoretically the profit on redemption per annum so determined is inaccurate (the inaccuracy increasing the length of the period lapsing between date of purchase or issue and date of redemption).

This arises in consequence of the fact that the one point (£1) profit is not received yearly, as is the dividend, but only upon the

expiry of the 10 years. A sum of £10 payable in 10 years is certainly not worth £10 now. Hence the true worth now (i.e. the present worth) is such a sum which, invested at such a rate of interest as is considered desirable and allowed to accumulate with yearly rests, will amount at the end of the ten years to £10.

As this is a matter of actuarial science, it will not be considered here. In practice if the precise figure is required, Tables supplying the information are available and, so far as examination work is concerned, the requisite figures would undoubtedly be supplied in the question paper.

AVERAGE

Weighted Average may be defined as the quotient of the sum of a series of items multiplied by their number, divided by the sum of their number; that is to say, it is the result achieved by multiplying each item in the series by its number (commonly called weight), such products being totalled, and then divided by the sum of the number of weights.

Illustration. Of 20 companies—

15 companies pay 10 per cent dividend;
5 companies pay 6 per cent dividend.

The average rate of dividend is 9 per cent, arrived at as follows—

$$\begin{array}{rcrcr} 15 & \times & 10 & = & 150 \\ 5 & \times & 6 & = & 30 \\ \hline 20 & & & & 180 \end{array}$$

∴ Average rate of dividend per company—

$$= \frac{180}{20} = 9\%$$

Illustration. A company's wage bill comprises the following—

			£
1,000 employees at	£3 per week	=	3,000
400 " "	£4 " "	=	1,600
100 " "	£5 " "	=	500
20 " "	£8 " "	=	160
5 " "	£12 " "	=	60
1,525	Total Wages	=	£5,320

Average weekly wage per employee—

$$= £\frac{5,320}{1,525} = £3\ 9s.\ 9\tfrac{1}{4}d.$$

It is clear that this average is no true criterion of the wages received by any specific employee, since 525 employees are receiving

£4 or over per week. The average is weighted heavily by the large bulk of the £3 per week employees.

Where the sales of a period are given, e.g. a year, and it is stated that the sales for specified months are a certain number of times as heavy as those in others, then to ascertain the amount of the Sales or the Gross Profit apportionable to any particular month, it will be necessary to weight the months accordingly.

Illustration. The Total Sales for the year = £7,600.

(*a*) The average sales for the first three months, January, February, and March, are three times as high as those for the last five months, August to December.

(*b*) The average sales for the four months, April to July, are twice as high as those for the first three months, January to March.

Taking the sales average of the last five months as the basic unit = 1, the first period's sales per month are three times as great = 3, and the second period's twice as great = 6.

The ratios in order of time are 3 : 6 : 1.

The average sales per month are—

(*a*)	Three months in ratio	3 : 1 =	9 units
(*b*)	Four " " "	6 : 1 =	24 "
(*c*)	Five " " "	1 : 1 =	5 "
			38 units

The average sales per month in the different periods will vary in the ratio, 3 : 6 : 1, as explained. The amounts of the various averages will be found as follows—

The total amount of sales effected in periods will be—

			Ratio
(*a*)	$\frac{9}{38}$ × £7,600 = £1,800 (3 months)	= £600 per month	3
(*b*)	$\frac{24}{38}$ × £7,600 = £4,800 (4 months)	= £1,200 "	6
(*c*)	$\frac{5}{38}$ × £7,600 = £1,000 (5 months)	= £200 "	1

It will thus be seen how it is necessary to weight the months in the proportion in which they contribute to the total sales in order to find the specific monthly or periodical figures for comparative purposes, etc.

CHAPTER IV

ACCOUNTS CURRENT AND AVERAGE DUE DATE

WHEN it is agreed that interest be charged in respect of transactions between parties it is usual, in order to facilitate calculations, to have a special column ruled adjacent to the ordinary column, on each side of the Ledger, this being purely "Memorandum." Such additional columns are employed merely on account of their usefulness in the calculation of interest, and having provided the amount thereof the columns have fulfilled their function. Hence the entry of interest into the ordinary columns of the Ledger must be posted to Interest Account, either through the Journal, or if the number of transactions of this kind should warrant it, through an Interest Journal or Day Book.

An Account Current, then, is a statement in account form of transactions of one person with another, duly set out in chronological order, with additional columns for the purpose of computing interest allowed or received, the net balance of which will be entered to the credit or debit of the account itself.

Before the methods employed in accounts current are dealt with, it will be necessary to observe the following points—

(1) The Account, save for Interest, will be an ordinary account, but just as the Bank Pass Book may contain the entries reverse to the sides in the bankers' book, i.e. to correspond with the entries in the customer's books, so the Account Current *may*, when rendered to a party, be reversed to correspond with the entries in the books of the person to whom it is sent.

Thus "Jones in Account Current with Brown" would represent the state of account of Jones in Brown's books; in other words, Jones is the accounting party, so that his account will be in debit for goods sold to him, charges, etc., and in credit for payments, discounts thereon, allowances, etc.

If, for the convenience of Jones, these sides are reversed, the heading will be "Brown in Account Current with Jones," and the entries will correspond to, and be on the same side as, those appearing in Jones's Ledger; that is, Brown will be in credit for goods he has supplied to Jones, and in debit for payments, discounts thereon, allowances, etc.

(2) In calculations of interest, if computed according to the number of days, the opening date, if it is the date on which the balance, if any, is brought down will be *included*, but if it is the date of the first transaction it will be *excluded*.

(3) Particular care is required in dealing with bills of exchange and forward-dated sales, as the due date of the bill and the

forward date of the sale are the material dates for the purpose of interest.

The methods adopted vary, and from an examination point of view it is advisable to be quite clear on *one* method and ignore the others.

The various methods are—

FIRST METHOD

Each item is taken separately and the number of days from the date opposite such item to the *end* of the period is ascertained and interest calculated at the agreed rate of interest for the requisite number of days.

SECOND METHOD

A modification of the above method is to employ the products system, i.e. instead of making separate calculations, each item is multiplied by the number of days from its date to the end of the period, and one interest calculation only is made on the net products for *one* day. It should be clear to the student that if there is interest on £150 for 10 days, this, when made into a product and treated by the products method, will be—Interest on £150 × 10 = £1,500 for one day; and this principle is employed herein.

THIRD METHOD

The other method of importance is the *Époque* method. Broadly speaking, the procedure is the reverse of those already explained. Interest is computed from the *commencement* of the period to the date of each item. Thus *no* Interest must be charged on the OPENING BALANCE,[1] but interest for the *whole* period of the account will be charged on the CLOSING BALANCE.[1]

Where interest is computed at a higher rate for debits than credits, or vice versa, there will be two calculations, one for the total debits and another for the total credits. This applies to all the above methods.

RED INK INTEREST

Where transactions are passed through an Account Current it is essential to compute interest from the due date, and not from the date of entry. As has been seen, an invoice may be dated forward, and, analogous to this, a bill of exchange may be payable at a future date. No particular difficulty is likely to arise so long as such future date falls *within* the period under review. Where, however, such due date occurs after the period of the account has terminated, the intervening time (i.e. between the close of such period and the due date) must be brought into consideration.

[1] Debit balances are here assumed. On the same principle interest will be credited for credit balances.

(1) **Ordinary Method.** Where an entry is made against the customer, and the due date arises after the close of the period, it can be seen that not only should no interest be charged, but CREDIT given for the time elapsing from the close of the period to the due date, because the item debited will be brought down as a balance for the new period, and consequently interest which should run from the due date will be charged as from the start of the new period.

The converse applies where the customer accepts (i.e. remits) a bill of exchange, due after the period in question has closed. The opening balance for the new period on which interest is calculated, will be unduly small. Accordingly it will be necessary to charge interest on the bill from the date of the close of the period to the due date of the bill.

Thus the interest will be normally on the *reverse* side to the relevant item, but it is customary to show it in *red ink* on the same side, to denote that it really belongs to the opposite side, and to connect it with its appropriate item. These *red ink* entries will be calculated separately from the others; that is, *red ink* entries on the debit side will be counted as credits, and *vice versa*, and if there are a number of *red ink* entries on both sides the balance only may be used for the interest calculation, provided that the rate of interest for debits and credits is the same.

(2) **Époque Method.** Under the *Époque* method, interest must be charged on the bill from the commencement of the period in which the bill is remitted to the due date of the bill, since the interest calculation for the whole period is made on the closing balance, and not on the opening balance, which is understated by the amount of the bill. Thus no *red ink* modifications are called for. The same principle applies to forward dated sales.

In order to prevent confusion it is submitted that it is preferable to avoid *red ink* interest, **and always to insert the interest upon its correct side.**

The rules may be formulated thus—

(1) **Ordinary Method.**

Where an entry is made within the period in question, but having a due date SUBSEQUENT to the close of such period, interest must be calculated for the time elapsing between the close of the period and the due date of the transaction, and shown on the *opposite* side to the principal entry, or, if the *red ink* principle is to be followed, the interest entry will be in *red ink* on the same side as the principal entry, to denote that its true side should be on the reverse of the account.

Alternatively, interest may be computed from the nominal date (on the usual lines) and shown in the ordinary way, and on the opposite side of the account an entry for interest may be made, for the length of time elapsing between nominal date and due date.

Illustration. A owes B on 1st January, 19.., £300 and on 31st March he remits a bill of exchange for £120 (seven months' date). Interest is charged at 5 per cent per annum (calculated in months, days of grace[1] ignored) the Account Current running to 30th June, 19...

It will be seen that the bill is not due till the end of October, and therefore the period elapsing from the end of June is four months; hence interest on £120 for four months will be debited to the account.

The various alternative methods which may be used are shown on pp. 44 to 45.

(2) Époque Method.

It must carefully be observed that under the *Époque* method the interest on the bill is calculated from the *commencement* of the period to the due date of the bill, and not from the date of the giving of the bill. Thus, in the above case, 10 months is the period upon which the calculation is based.

The same principle applies when items are *charged* within the period of the Account Current, and the due date falls after the end thereof—

Illustration.

	£
On 1st January, 19.., A owes B	200
,, 1st March, 19.., A remits cash	50
,, 1st April, 19.., A buys goods from B (due date, 1st September)	120
,, 1st May, 19.., A remits an 8 months' bill	100

Show Account Current rendered by B to A (ignore days of grace[1]) for half-year to 30th June, 19.. calculating interest at 5 per cent per annum. See Account (1) on page 46.

Alternatively, the Account Current may be stated by taking the nominal date of the goods and the bill as the true date and calculating the number of months from the nominal date to the actual date on the *contra*, as in Account (2) on page 46, i.e.—

(1) Instead of calculating *red ink* interest on the bill for six months, interest will be calculated as if the bill were due on the date given, i.e. 1st May—two months interest and *contra* interest for the period of the bill, i.e eight months; thus the difference "*contra*" is six months as in the previous example (see items *q* and *r* in Account (2) and *b* in Account (1)).

(2) Instead of calculating *red ink* interest on the goods for two months, interest will be calculated as if the invoice for the goods were dated 1st April—three months interest and *contra* interest for the period elapsing between 1st April and 1st September—five months; thus the difference is two months as in the previous example (see items *x* and *y* in Account (2) and *a* in Account (1)).

[1] See page 147.

(1) FIRST METHOD

Dr — A in Account Current with B — *Cr.*

Date	Details		Mos	Interest	Principal	Date	Details		Mos	Interest	Principal
19 .				£ s d	£ s d	19 .				£ s. d	£ s d.
Jan 1	To Balance .	b/d	6	7 10 0	300 0 0	Mar 31	By Bill of Exchange, due 31st Oct				120 0 0
June 30	,, Interest on Bill		4	2 0 0		June 30	,, Balance of Interest to *Contra*			9 10 0	
	,, Interest from *Contra*				†9 10 0		Balance .	c/d			189 10 0
				£9 10 0	£309 10 0					£9 10 0	£309 10 0
July 1	To Balance .	b/d			189 10 0						

Note Interest at 5% per annum = one penny in the £ per month E g Interest on £120 for 4 months at 5% = 480 pence = £2

† The double entry will be effected by debiting the above account and crediting Interest Account through the Journal The Interest columns in the above account are purely 'memorandum"

(2) FIRST METHOD—Alternative

Dr — A in Account Current with B — *Cr.*

Date	Details		Mos	Interest	Principal	Date	Details		Mos	Interest	Principal
19				£ s d	£ s d	19 .				£ s d	£ s. d
Jan 1	To Balance .	b/d	6	7 10 0	300 0 0	Mar 31	By Bill of Exchange due 31st Oct		3	1 10 0	120 0 0
June 30	,, Interest on Bill		7	3 10 0		June 30	,, Balance of Interest to *Contra*			9 10 0	
	,, Interest from *Contra*				9 10 0		,, Balance .	c/d			189 10 0
				£11 0 0	£309 10 0					£11 0 0	£309 10 0
July 1	To Balance .	b/d			189 10 0						

(3) PRODUCTS METHOD

A in Account Current with B

Date	Details		Mos.	Products	Principal	Date	Details		Mos.	Products	Principal
19..					£ s. d.	19..					£ s. d.
Jan. 1	To Balance . .	b/d	6	1,800	300 0 0	Mar. 31	By Bill of Exchange due 31st Oct. . .				120 0 0
June 30	,, Products on Bill		4	480		June 30	,, Balance of Products to *contra* . .			2,280	
	,, Interest on Products from *contra* of £2,280 for 1 mth. at 5% per annum				9 10 0		,, Balance . .	c/d			189 10 0
				2,280	£309 10 0					2,280	£309 10 0
July 1	To Balance .	b/d			189 10 0						

(4) ÉPOQUE METHOD

Dr. A in Account Current with B *Cr.*

Date	Details		Mos.	Products	Principal	Date	Details		Mos.	Products	Principal
19..					£ s. d.	19..					£ s. d
Jan. 1	To Balance .	b/d			300 0 0	Mar. 31	By Bill of Exchange due 31st Oct. . .		10	1,200	120 0 0
June 30	,, Balance of Products .			2,280		June 30	,, Balance of Account [i.e. £300 less £120] £180		6	1,080	
	,, Interest on balance of Products of £2,280 for 1 month at 5% per annum				9 10 0		,, Balance . .	c/d			189 10 0
				2,280	£309 10 0					2,280	£309 10 0
July 1	To Balance .	b/d			189 10 0						

Dr. (1) A IN ACCOUNT CURRENT WITH B *Cr.*

Date	Details		Mos.	Interest	Principal	Date	Details		Mos.	Interest	Principal
19..				£ s. d.	£ s. d.	19..				£ s. d.	£ s. d.
Jan. 1	To Balance . .	b/d	6	5 0 0	200 0 0	Mar. 1	By Cash . . .		4	16 8	50 0 0
April 1	„ Goods (dated 1st Sept.) . (*a*)				120 0 0	May 1	„ Bill due 1st Jan. (*b*)				100 0 0
June 30	„ Interest on Bill (*b*)		6	2 10 0		June 30	„ Interest on Goods (*a*)		2	1 0 0	
	„ Interest from *Contra*				5 13 4		„ Balance of Interest to *Contra* . .			5 13 4	
							„ Balance .	c/d			175 13 4
				£7 10 0	£325 13 4					£7 10 0	£325 13 4
July 1	To Balance . .	b/d			175 13 4						

Dr. (2) A IN ACCOUNT CURRENT WITH B *Cr.*

Date	Details		Mos.	Interest	Principal	Date	Details		Mos.	Interest	Principal
19..				£ s. d.	£ s. d.	19..				£ s. d.	£ s. d.
Jan. 1	To Balance . .	b/d	6	5 0 0	200 0 0	Mar. 1	By Cash . . .		4	16 8	50 0 0
April 1	„ Goods (dated 1st Sept.) . (*x*)		3	1 10 0	120 0 0	May 1	„ Bill due 1st Jan. (*r*)		2	16 8	100 0 0
June 30	„ Interest on Bill (*q*)		8	3 6 8		June 30	„ Interest on Goods (*y*)		5	2 10 0	
	„ Interest from *Contra* . .				5 13 4		„ Interest to *Contra* .			5 13 4	
							„ Balance .	c/d			175 13 4
				£9 16 8	£325 13 4					£9 16 8	£325 13 4
July 1	To Balance . .	b/d			175 13 4						

The preceding examples have been worked on the ordinary and conventional rules, but from a purely academic point of view where Red Ink interest occurs the correct procedure is to bring the interest down to the following period in the Interest column, and not to add it to the principal (or deduct as the case may be), because the result should be exactly the same as that where cash is paid on the due date of the bill without the intervention of any bill transaction. The interest calculation in the period in which the bill matures should not be affected by the bill transaction.

Illustration. A owes B £300 on 1st January 19.. in respect of which debt B receives a 7 months' bill for £120. Assuming no further transactions occur, and that the bill is met at its due date, show the Account Current in the books of B to 30th June, 19.., and 31st December, 19.., taking interest at 5 per cent per annum and ignoring days of grace.

(1) The method academically correct is given in the first example on page 48.

(2) The Account Current drawn up under any of the methods indicated before would show a balance on 31st December, 19.., of £194 4s. 9d., as shown in the second example on page 48.

The difference is accounted for by the balance at 30th June being brought down as £189 10s. as distinct from £187 10s., that is £2 at 5 per cent for half-year = 1s.

Change in Rate. It frequently occurs that during the period under review the rate of interest is changed. In this event, probably the simplest method is to strike a balance of the principal on the date that the rate changes, calculate the interest to that date, and then calculate interest at the new rate on the balance of the principal to the end of the period. Care should be taken, of course, not to transfer the interest to the principal column before the end of the complete period.

Illustration.

19..			£
Jan.	1.	Balance due to Brown	400
Mar.	31.	Jones remits Cash to Brown	250
Apr.	14.	Brown sells Goods to Jones (dated 15th May) .	50
May	1.	Jones sells Goods to Brown	20

Interest to be calculated at 5 per cent per annum up to the 6th April, when it changes to 6 per cent per annum.

Show Account Current to 30th June, calculating in days.

The Account Current is given on page 49.

Periodic Balance Method. Under this method interest is reckoned on the balance (if any) from the commencement of the period until the date of the next transaction, when the revised balance is struck and interest is computed on it, in its turn, from such date to the date of the next transaction, this process being continued throughout the period of the account.

Thus interest is reckoned in stages, each being measured by the length of time the balance remains unchanged.

Dr (1) A in Account Current with B *Cr.*

Date	Details		Mos	Interest	Principal	Date	Details		Mos.	Interest	Principal
19..				£ s. d	£ s. d.	19..				£ s. d.	£ s. d.
Jan 1	To Balance . .	b/d	6	7 10 0	300 0 0	Mar. 31	By Bill due 31st Oct. . .				120 0 0
June 30	,, Interest on Bill .		4	2 0 0		June 30	,, Interest to *Contra* . .			7 10 0	
	,, Interest from *Contra*				7 10 0		,, Balance . . .	c/d		2 0 0	187 10 0
				£9 10 0	£307 10 0					£9 10 0	£307 10 0
July 1	To Balance .	b/d		2 0 0	187 10 0	Dec. 31	By Interest to *Contra* . .			6 13 9	
Dec. 31	,, Interest on £187 10s. at 5% for 6 months .		6	4 13 9			,, Balance . . .	c/d			194 3 9
	,, Interest from *Contra*				6 13 9						
				£6 13 9	£194 3 9					£6 13 9	£194 3 9
19 Jan. 1	To Balance . .	b/d			194 3 9						

Dr. (2) A in Account Current with B *Cr.*

Date	Details		Mos.	Interest	Principal	Date	Details		Mos.	Interest	Principal
19..				£ s. d.	£ s. d.	19..				£ s. d.	£ s. d.
Jan. 1	To Balance . .	b/d	6	7 10 0	300 0 0	Mar. 31	By Bill due 31st Oct. .				120 0 0
June 30	,, Interest on Bill . .		4	2 0 0		June 30	,, Interest to *Contra* .			9 10 0	
	,, Interest from *Contra* .				9 10 0		,, Balance .	c/d			189 10 0
				£9 10 0	£309 10 0					£9 10 0	£309 10 0
July 1	To Balance . .	b/d	6	4 14 9	189 10 0	Dec. 31	By Interest to *Contra* . .			4 14 9	
Dec. 31	,, Interest from *Contra* .				4 14 9		,, Balance . .	c/d			194 4 9
				£4 14 9	£194 4 9					£4 14 9	£194 4 9
19.. Jan. 1	To Balance .	b/d			194 4 9						

Jones in Account Current with Brown

Dr. | *Cr.*

Date	Details		Days	Rate	Interest	Principal	Date	Details		Days	Rate	Interest	Principal
19					£ s. d.	£ s. d.	19 .					£ s. d.	£ s. d.
Jan. 1	To Balance . .	b/d	96	5%	5 5 3	400 0 0	Mar. 31	By Cash . .		6	5%	4 1	250 0 0
							April 6	,, Balance of Interest .	c/d			5 1 2	
								,, Balance of Principal .	c/d				150 0 0
					£5 5 3	£400 0 0						£5 5 3	£400 0 0
April 6	To Balance of Interest .	b/d			5 1 2		May 1	By Goods . . .		60	6%	3 11	20 0 0
	,, Balance of Principal .	b/d	85	6%	2 1 11	150 0 0	June 30	,, Interest to *Contra* .				7 6 9	
14	,, Goods (dated 15th May)		46	6%	7 7	50 0 0		,, Balance . . .	c/d				187 6 9
June 30	,, Interest from *Contra* .					7 6 9							
					£7 10 8	£207 6 9						£7 10 8	£207 6 9
July 1	To Balance . .	b/d				187 6 9							

Any other of the methods of drawing up an account current enumerated in this chapter may be adapted in the same way so as to allow of a change or changes of interest during the period, so long as the interest is not prematurely introduced into the principal column.

This method is particularly suitable for interest calculations in banking accounts, but it may also be applied to ordinary accounts. Its use will necessitate alteration in the form of the Account Current inasmuch as it entails the striking of a new balance on the occasion of any transaction relating to the account. It must be clearly observed that where in a banking account a higher rate of interest is charged on overdrafts than is allowed on amounts in credit, this is quite different from the system of charging one rate on all debits and allowing another on all credits, because in calculating Bank Interest the TEMPORARY BALANCE is the material factor.

Illustration.

19..		£
Jan. 1.	Balance due to Brown	400
Mar. 31.	Jones remits cash to Brown	250
Apl. 14.	Brown sells goods to Jones (dated 15th May) .	50
May 1.	Jones sells goods to Brown	20

Show Account Current to 30th June in Brown's books.
Interest to be calculated at 5 per cent per annum.
Calculate in (*a*) days and (*b*) months.

JONES IN ACCOUNT CURRENT WITH BROWN

Date	Debits	Credits	*Dr.* Balance	*Cr.* Balance	(*a*) Days Unchanged	(*a*) Products	(*b*) Months Unchanged	(*b*) Products
19..	£	£	£	£				
Jan. 1			400		90	36,000	3	1,200
Mar. 31		250	150		31	4,650	1	150
May 1		20	130		14	1,820	½	65
15	50		180		46	8,280	1½	270
					181	50,750	6	1,685

(*a*) Interest on £50,750 for 1 day at 5% per annum £ s. d.

$$= £\frac{50,750 \times 10}{73,000} = 6\ 19\ 0$$

(*b*) Interest on £1,685 for 1 month at 5% per annum

$$= £\frac{1,685 \times 10}{200 \times 12} = 7\ 0\ 5$$

[or, being a penny in the £ per month, 1,685 pence]

The difference in the results of the different interest calculations is due to the fact of—

(*a*) 14 days being treated as ½ month.
(*b*) Difference in the length of months.
(*c*) Six months are treated as 182½ days, i.e. one half of 365 days.

Illustration. T. Jones, a customer, had the following transactions with the Central Bank during the half-year to 30th June, 19..

He drew out as follows—

19..		£	19..		£
Jan.	6 . .	100	April	2 . .	950
	18 . .	180	May	1 . .	110
Feb.	22 . .	100	June	1 . .	40
Mar.	14 . .	300		10 . .	80

And paid in as follows—

19..	£	19..	£
Jan. 31 . .	80	April 30 . .	160
Feb. 16 . .	50	May 8 . .	30
Mar. 2 . .	500	24 . .	80
12 . .	400	28 . .	30
31 . .	150	June 25 . .	520

His balance at 1st January, 19.. was in credit to the extent of £300. You are required to show T. Jones's account in the books of the bank having regard to the following—

(1) 2½ per cent per annum is allowed on credit balances.[1]
(2) 5 per cent per annum is charged on debit balances.
(3) Commission charged at rate of 1s. per £100 on sums paid in.

T. JONES IN ACCOUNT WITH THE CENTRAL BANK, LTD.

Date	Particulars	Debits	Credits	Balances		No. of Days	Products	
				Dr.	*Cr.*		Debits	Credits
19..		£ *s.* *d.*	£ *s.* *d.*	£	£			
Jan 1	Balance . .		300 0 0		300	6		1,800
6		100 0 0			200	12		2,400
18		180 0 0			20	13		260
31			80 0 0		100	16		1,600
Feb. 16			50 0 0		150	6		900
22		100 0 0			50	8		400
Mar. 2			500 0 0		550	10		5,500
12			400 0 0		950	2		1,900
14		300 0 0			650	17		11,050
31			150 0 0		800	2		1,600
April 2		950 0 0		150		28	4,200	
30			160 0 0		10	1		10
May 1		110 0 0		100		7	700	
8			30 0 0	70		16	1,120	
24			80 0 0		10	4		40
28			30 0 0		40	4		160
June 1		40 0 0				9		
10		80 0 0		80		15	1,200	
25			520 0 0		440	5		2,200
30	Interest . .		1 1 1				7,220	29,820
	Commission . .	1 0 0						
	Balance . c/d	440 1 1						
	£	2301 1 1	2301 1 1					
19.. July 1	Balance . b/d		440 1 1					

[1] Interest is not normally allowed nowadays on current accounts.

The interest is ascertained as follows—

		£	s.	d.
Interest receivable = $2\frac{1}{2}\%$ p.a. on £29,820 for 1 day	=	2	0	10
Interest payable = 5% p.a. on £7,220 for 1 day	=		19	9
∴ Net Interest receivable	=	£1	1	1

The commission is ascertained as follows—

Total payments into bank = £2,000
1s. per cent of £2,000 = £1

Note. The £300 balance has already borne commission during the preceding year.

AVERAGE DUE DATE

This may be defined as the mean or equated date on which one payment may be made in lieu of several payments due on a series of dates.

It is used in connection with the settlement of *contra* accounts; accounts which are to be settled by a series of bills; the calculation of interest on partners' Drawings Accounts; the piecemeal realization of assets during a partnership dissolution; and other transactions of a similar nature.

The method of arriving at the average due date is as follows—

(1) A certain convenient basic date is taken as a starting point from which all calculations have to be made. This starting point should preferably be the due date of the earliest transaction.

(2) The number of days (or months) that the due date of each transaction is distant from the basic point must then be ascertained.

(3) Each item (usually taken to the nearest £) is multiplied by its distance (measured in terms of days or months) from the basic point.

(4) The products are totalled and divided by the total of the various amounts.

(5) The result is the number of days (or months) that the average due date is distant from the chosen basic date.

Illustration. A owes B the following sums of money due on the dates stated—

£		
100	due	4th March
160	,,	23rd April
40	,,	1st May
200	,,	15th May
500	,,	31st July

He desires to make one payment on the average due date, which will be ascertained as follows—

Date	Amount	Time from 4th March in days	Product
19..	£		
Mar. 4	100	0	
April 23	160	50	8,000
May 1	40	58	2,320
15	200	72	14,400
July 31	500	149	74,500
	£1,000		99,220

Calculation

$$\frac{99,220}{1,000} = 99 \text{ (to the nearest whole number)}$$

∴ The average due date is 99 days from 4th March = 11th June.

It is not, of course, compulsory to take as a base the date of the first amount due. In fact any date may be taken so long as it lies between the first and last dates.

Illustration. Using the previous illustration, but taking 5th May as the basic date—

Date	Amount	Time from 5th May in days		Product	
		Before −	After +	Before −	After +
19..	£				
Mar. 4	100	62		6,200	
April 23	160	12		1,920	
May 1	40	4		160	
15	200		10		2,000
July 31	500		87		43,500
	£1,000			− 8,280	+ 45,500
					8,280
				Net Product	37,220

Calculation

$$\frac{37,220}{1,000} = 37 \text{ days } \textit{after} \text{ 5th May (to the nearest whole number)}$$

$$= \text{11th June}$$

Illustration. Similarly, the end date may be used as the basic date.

Date	Amount	Time from 31st July in days	Product
19..	£		
Mar. 4	100	149	14,900
April 23	160	99	15,840
May 1	40	91	3,640
15	200	77	15,400
July 31	500	0	
	£1,000		49,780

Calculation

$$\frac{49{,}780}{1{,}000} = \text{50 days \textit{before} 31st July (to the nearest whole number)}$$
$$= \text{11th June}$$

As has been mentioned above, the ascertainment of the average due date is often the quickest method of ascertaining the interest that should be charged on a series of transactions which bear interest over a period (e.g. partners' drawings).

Illustration. A, a partner in the firm A B & Co., draws out from the business the following amounts during 19.. upon which he is to be charged interest at 7 per cent per annum.

19..	£	19..	£
Jan. 31 . . .	150	July 31 . . .	250
Feb. 28 . . .	100	Aug. 31 . . .	150
Mar. 31 . . .	160	Sept. 30 . . .	120
April 30 . . .	200	Oct. 31 . . .	100
May 31 . . .	140	Nov. 30 . . .	180
June 30 . . .	70	Dec. 31 . . .	316

The best way to deal with a question of this type is to ascertain the average due date working in months and then find the amount of interest at 7 per cent per annum on £1,936 (the total amount of drawings) for the period from the average due date to 31st December, 19.. The average due date will be ascertained as follows—

		End date being used as basic date		Commencing date being used as basic date	
	Amounts	Months before 31st Dec.	Product	Months after 1st Jan.	Product
19..	£				
Jan. 31	150	11	1,650	1	150
Feb. 28	100	10	1,000	2	200
Mar. 31	160	9	1,440	3	480
April 30	200	8	1,600	4	800
May 31	140	7	980	5	700
June 30	70	6	420	6	420
July 31	250	5	1,250	7	1,750
Aug. 31	150	4	600	8	1,200
Sept. 30	120	3	360	9	1,080
Oct. 31	100	2	200	10	1,000
Nov. 30	180	1	180	11	1,980
Dec. 31	316	0	0	12	3,792
	£1,936		9,680		13,552

Therefore the average due date is—

$\frac{9,680}{1,936}$ months prior to 31st December, i.e. 5 months
= 31st July

Alternatively, calculating from 1st January, the average due date is—

$\frac{13,552}{1,936}$ months subsequent to 1st January, i.e. 7 months
= 31st July

Accordingly the amount of interest that must be charged to A is: interest at 7 per cent per annum on £1,936 for five months = £56 9s. 4d.

Illustration. A owes B £400, due 31st January; A owes B £600, due 30th April; B owes A £300, due 31st March. Find the average due date for a settlement in one sum. Calculate in months.

A to B				B to A			
	Amt. £	Mths.	Products		Amt. £	Mths.	Products
Jan. 31 .	400	0	0	Mar. 31 .	300	2	600
Apr 30 .	600	3	1,800				
	£1,000		1,800		£300		600

Average due date: $\frac{1,800 - 600 \div 700}{700}$ = $1\frac{5}{7}$ months from 31 Jan., say, 22 Mar.

If the average due date is required for a fixed amount, it is found by taking the aggregate of the number of days (or months or years), divided by the sum of the number of days (or months or years), such quotient being the number of days (or months or years) from the commencement.

Illustration. £10,000 lent on 1st January, 1953, is repayable in five equal annual instalments commencing 1st January, 1954. Find the average due date.

$$\frac{1 + 2 + 3 + 4 + 5}{5} = \frac{15}{5} = 3 \text{ years from 1st}$$

January, 1953, i.e. 1st January, 1956.

CHAPTER V

TRADING AND PROFIT AND LOSS ACCOUNT—BALANCE SHEET

MOST students will already have familiarized themselves to a greater or lesser degree with the nature of the items appearing in the Trading and Profit and Loss Account and the Balance Sheet. The following pages are devoted to the principles and difficulties of this topic; problems of an advanced nature will be dealt with as they arise in connection with Partnerships and Limited Companies in the chapters on those subjects.

DEFINITIONS

Gross Profit and Gross Loss. Gross profit is the excess of the sales (less returns) over the cost of the goods sold including the expenses directly attributable to putting the goods in a saleable condition. The cost of the goods sold is the amount of the opening stock plus purchases (less returns), less the amount of the closing stock—not merely the amount of goods *purchased*. A gross loss is the converse of a gross profit.

Net Profit and Net Loss. Net profit is the surplus remaining after charging against gross profit all the expenses, including depreciation and other necessary provisions, properly attributable to the normal activities of the particular business. A net loss is the converse of a net profit.

FUNCTIONS OF THE FINAL ACCOUNTS[1]

The final accounts consist of (*a*) Trading Account, (*b*) Profit and Loss Account, (*c*) Profit and Loss Appropriation Account and (*d*) Balance Sheet.

The aim of the Trading Account is to ascertain the gross profit or gross loss for a certain period, that of the Profit and Loss Account is to ascertain the net profit or net loss for the same period. It is customary to keep the two accounts quite separate, but where the gross profit or gross loss figure is neither required nor desired, one combined account may be employed. It is usual, too, instead of showing the two accounts as separate *accounts*, headed "Trading Account" and "Profit and Loss Account," to show them as one account with two *sections*, with the balance brought down from one to the other, headed "Trading and Profit and Loss Account."

[1] For the present, attention is confined to Trading and Profit and Loss Accounts, so that all references to other methods of showing business activities, e.g. Manufacturing Accounts, are excluded.

The aim of the Profit and Loss Appropriation Account is to show all dispositions, divisions and appropriations of the net profit. Thus, whereas all expenses incurred in the gaining of the net profit, such as loan interest, depreciation, rent, rates, wages and the like, are chargeable to the Profit and Loss Account, the Appropriation Account will be debited with such items as Manager's commission (where intended to be a *division* of profits), interest on capital of a partner, dividends to shareholders of a limited company, etc. Similarly all income properly attributable to the ordinary business activities will be credited to the Profit and Loss Account, and not to the Appropriation Account.

The vital distinction between the Profit and Loss Account and the Appropriation Account is particularly applicable to the accounts of limited companies and the topic receives attention in Chapter XXIII.

The Appropriation Account is not usually used in the accounts of a sole trader, non-business expenses, such as drawings, being debited direct to Capital Account, or, where it is desired to keep the capital figure intact, to a Current Account to which also the net profit is credited.

The aim of the Balance Sheet is to show in summary form the financial state of the concern as disclosed by the books, and to that end will be scheduled the assets, liabilities, reserves and capital as they exist upon a given date.

The Trading and Profit and Loss Account is (as its name implies) an ACCOUNT and its construction conforms to the rules of double-entry, whereas the Balance Sheet is quite definitely not an account, but a mere SUMMARY OF ACCOUNTS APPEARING IN THE LEDGER AFTER ADJUSTMENT OF THE PROFIT AND LOSS ACCOUNT. It will therefore be comprised of all items that are not transferred to the Trading and Profit and Loss Account, including the closing stock as introduced into the books. Hence, as the Trading and Profit and Loss Account absorbs, as it were, Nominal items, the Balance Sheet will be made up only of assets and liabilities, including closing stock and Capital.

Its form—that is, reverse to the actual side of the Ledger on which the particular item appears—should cause no difficulty so long as the student treats every item consistently. In accordance with English custom, assets are shown on the right hand of the Balance Sheet and liabilities and capital on the left hand. The terms "debit side" and "credit side" of the Balance Sheet are frequently employed, but it is preferable to refer to them as mentioned above: left and right hand.

Finally, as the Trading and Profit and Loss Account contains the results of operations over a period, the heading should be "Trading and Profit and Loss Account FOR THE YEAR (or other period) ENDED . . ."; the Balance Sheet, on the other hand, is a statement of the financial position AT a stated date and hence should be headed

"BALANCE SHEET AS AT (or ON) (or AT) . . . . . ." For example, if final accounts are drawn up as a result of operations for the half-year to 30th April, 19.., the Trading and Profit and Loss Account will be headed—

TRADING AND PROFIT AND LOSS ACCOUNT FOR THE HALF-YEAR ENDED
Dr. 30TH APRIL, 19.. *Cr.*

The Balance Sheet at the close of the period will be headed—

BALANCE SHEET AS AT 30TH APRIL, 19..

RULES FOR CONSTRUCTION OF FINAL ACCOUNTS

(1) **Trading Section of the Trading and Profit and Loss Account.** The items usually appearing in this account are—

(*a*) DEBIT SIDE.	Opening Stock.
	Purchases.
	Carriage Inwards.
	Wages.
(*b*) CREDIT SIDE	Sales.
	Closing Stock.

The Trial Balance will include opening, but not closing, stock; stock at the end of the period must therefore be "taken" and valued and be incorporated in the accounts by means of the following Journal entry—

Stock . . . . . *Dr.*
To Trading Account . .

When this entry is posted, the closing stock will appear on the debit side of the Stock Account and on the credit of the Trading and Profit and Loss Account.

As many students experience great difficulty in dealing with the Stock entries, the following is given by way of illustration. The Trial Balance at 31st December, 1952, contains an item Stock (1st January, 1952) £1,000, and on taking stock at 31st December, 1952, the stock on hand is valued at £1,500. The opening stock (£1,000) will have been incorporated into the books at 31st December, 1951, and have been shown in the Balance Sheet at that date as an asset, and will accordingly be a debit balance in the books throughout 1952. At 31st December, 1952, it will be transferred to the Trading Account by debiting that account and crediting Stock. The closing stock (£1,500) will be introduced into the books by debiting Stock and crediting Trading Account. The new stock will thus appear as an asset in the Balance Sheet and will remain as a debit balance throughout 1953. The Stock Account will appear thus—

Dr. STOCK *Cr.*

		£			£
1951 Dec. 31	To Trading A/c [1951] .	[1]1,000	1952 Dec. 31	By Trading A/c [1952] .	1,000
1952 Dec. 31	To Trading A/c [1952] .	[2]1,500			

If, as occasionally happens in examination questions, the closing stock is given as part of the Trial Balance, the presumption is that the Trading Account has already been prepared prior to the extraction of the Trial Balance; that is, the opening stock, purchases and sales and the necessary double-entry for the inclusion of the closing stock, have already been disposed of in the Trading Account. Reference to the Trial Balance will normally confirm this supposition, in that it will include gross profit as a separate balance. In these circumstances the closing stock will be shown in the Balance Sheet as an asset without adjustment.

The Trading Section will be closed off and the balance, being Gross Profit or Loss, carried down to the Profit and Loss Section.

(2) **Profit and Loss Section.** The expenses incurred in carrying on the affairs of a concern will vary in accordance with circumstances. The following is a list of the usual expenses—

Wages and Salaries.
Rent and Rates.
Insurance.
Discounts Allowed.
Stationery.
Postages.
Advertising.
Carriage Outwards.
Depreciation.
Bad Debts.
Loan Interest.
Heating and Lighting.
Repairs and Renewals.
Telephone.
Accountancy and Legal Expenses
Motor Expenses.
Bank Charges.
Travelling Expenses.
Distributing Expenses generally.
Royalties.
Selling Commission.

Expenses of a special nature (e.g. those peculiar to Limited Companies, such as Directors' Fees, Debenture Interest) are not included here, but will receive mention in their appropriate place.

Certain items representing gains will be found on the credit side of the Profit and Loss Account. Such are—

Discounts Received.
Bank Interest.
Recoveries or Part Recoveries of Bad Debts.
Selling Bonuses.
Profit on the Sale of Assets.
Income from Investments.

The Profit and Loss Section will be closed off and the balance, being Net Profit or Loss carried to Capital or Current Account (or Appropriation Account where applicable).

[1] An asset in the Balance Sheet at 31st December, 1951.
[2] An asset in the Balance Sheet at 31st December, 1952.

(3) **Balance Sheet.** The balances remaining in the books, comprised of Assets, Liabilities and Capital, will be extracted to form the schedule or statement known as the Balance Sheet. They are not "transferred" but merely extracted in the form of a statement and comprise the opening entries for the succeeding period.

The Balance Sheet may be looked upon as the "Trial Balance" *after* the transfer into one combined account of Purchases, Sales and Expenses, including the incorporation of the closing Stock and the transfer to Capital Account of the net profit or loss for the period.

It is important to observe that the amount shown in Drawings Account is transferred to Capital Account (and NOT to Profit and Loss Account) so that the Capital Account will in normal circumstances be made up of (1) Capital at the commencement of the period, (2) less Drawings, (3) plus net Profit (or less net Loss) for the period.

The general rules are shown by the following illustration.

Illustration. The following balances have been extracted from the books of H. Jones, retail merchant, at 31st December, 19.., and a TRADING and PROFIT and LOSS ACCOUNT and a BALANCE SHEET have been prepared from them. The closing stock at 31st December, 19.. was £450. The Ledger accounts are appended in detail to amplify and clarify the processes called for in the preparation of final accounts.

The balances remaining in the books agree with the items set out in the Balance Sheet below—except that in the Ledger accounts the assets are "debits" and liabilities and capital are "credits."

H. JONES

TRIAL BALANCE AS AT 31ST DECEMBER, 19..

	Folio	*Dr.*	*Cr.*
		£	£
Fixtures and Fittings	1	2,000	
Stock (as at 1st January, 19..)	2	600	
Purchases	3	7,200	
Sales	4		10,800
Debtors	5	3,000	
Creditors	6		1,800
Expenses	7	500	
Drawings	8	450	
Cash	9	20	
Capital (as at 1st January, 19..)	10		1,170
		£13,770	£13,770

H. JONES

Trading and Profit and Loss Account for the Year Ended 31st December, 19

Dr			£				£ Cr
19 Jan 1	To Stock (*x*)[1]	2	600	19 Dec 31	By Sales	4	10,800
Dec 31	„ Purchases	3	7,200		„ Stock (*y*)[1]	2	450
	„ Gross Profit	c/d	3,450				
			£11,250				£11,250
Dec 31	To Expenses	7	500	Dec 31	By Gross Profit	b/d	3,450
	„ Net Profit, transferred to Capital Account	10	2,950				
			£3 450				£3 450

Balance Sheet as at 31st December, 19

	£		£			£
Capital at 1st Jan, 19	1 170			Fixed Assets—		
Less Drawings	450			Fixtures and Fittings	1	2,000
	720			Current Assets—		
Add Net Profit	2 950			Stock	2	450
		10	3,670	Debtors	5	3 000
Current Liabilities—				Cash	9	20
Creditors		6	1,800			
			£5 470			£5,470

1

Fixtures and Fittings

Dr.			£				Cr
19 Dec 31	To Sundries		2,000				

2

Stock

Dr.			£				£ Cr
19 Jan 1	To Balance	b/d	600	19 Dec 31	By Trading Account		600
Dec 31	To Trading Account		450				

3

Purchases

Dr.			£				£ Cr
19 Dec 31	To Sundries		7 200	19 Dec 31	By Trading Account		7,200

[1] See page 64 (*A*) (1) and (5)

4

Dr. SALES **Cr.**

19 . Dec. 31	To Trading Account .		£ 10,800	19.. Dec. 31	By Sundries . .		£ 10,800

5

Dr. DEBTORS **Cr.**

19.. Dec. 31	To Sundries .		£ 3,000				

6

Dr. CREDITORS **Cr.**

				19 . Dec 31	By Sundries . .		£ 1,800

7

Dr. EXPENSES **Cr.**

19 Dec 31	To Sundries		£ 500	19 Dec 31	By Profit and Loss Account . .		£ 500

8

Dr. DRAWINGS **Cr.**

19 . Dec 31	To Sundries .		£ 450	19 Dec 31	By Capital Account .	10	£ 450

9

Dr. CASH **Cr.**

19 . Dec 31	To Sundries . .		£ 20				

10

Dr. CAPITAL **Cr.**

19. Dec 31	To Drawings . .	8	£ 450	19 . Jan. 1	By Balance . .	b/d	£ 1,170
	,, Balance . .	c/d	3,670	Dec 31	,, Profit and Loss Account . .		2,950
			£4,120				£4,120
				19.. Jan. 1	By Balance . .	b/d	3,670

The elementary rules may now be formulated—

(*A*) **Trading Account.**

(1) Opening Stock—

Debit Trading.[1]	Credit Stock.

(See item *x* in preceding illustration, page 62.)

(2) Purchases—

Debit Trading.	Credit Purchases.

(3) Expenses (Trading)

Debit Trading.	Credit Expenses.

(4) Sales

Debit Sales.	Credit Trading.

(5) Closing Stock (which is *not* in the Trial Balance).

Debit Stock.	Credit Trading.

(See item *y* in preceding illustration, page 62.)

The Closing Stock so introduced will now appear as a balance in the Ledger and therefore as an Asset in the Balance Sheet.

(6) The balance of Trading will be carried down to Profit and Loss by the entry—

(*a*) If a profit—

Debit Trading.	Credit Profit and Loss.[2]

(*b*) If a loss—

Debit Profit and Loss.	Credit Trading.

(*B*) **Profit and Loss Account.**

(1) There will be a balance, being either Gross Profit (credit) or Gross Loss (debit) from Trading (as shown in (*A*) (6) above).

(2) Expenses (Profit and Loss)

Debit Profit and Loss.	Credit Expenses.

(3) Sundry income (e.g. Discounts received).

Debit the appropriate account (e.g. Discounts Received).	Credit Profit and Loss.

(4) The balance of Profit and Loss will be transferred to Capital Account by the entry—

(*a*) If a Profit.

Debit Profit and Loss.	Credit Capital.

(*b*) If a Loss.

Debit Capital.	Credit Profit and Loss.

[1] "Trading" here refers to the Trading section of the Trading and Profit and Loss Account.

[2] "Profit and Loss" here refers to the Profit and Loss section of the Trading and Profit and Loss Account.

ADJUSTMENTS

When preparing final accounts it will be necessary to consider the question of the period in respect of which an expense has been incurred. It is easy to realize that at any given date, an expense may have been paid, or charged if an Expenses Day Book is used, in respect of a period which is not co-extensive with the period of accounts, either falling short of, or stretching beyond such period, and as it is essential that the period for which accounts are prepared should bear the true expenditure—no more, no less—an adjustment is usually called for to give effect to this principle. Where a payment is made in respect of a period beyond the date of the accounts it is in the nature of an asset; that is, the benefit of the expenditure is still to be derived and by so treating it the subsequent period bears the incidence of the expenditure. Conversely, if a payment for expenditure does not cover the whole period in question, provision has to be made for accruals, and this will be in the nature of a liability, and by so treating it relief will be made to the subsequent period, which will have debited against it the payment of the expense which has arisen in the preceding period.

In order to ensure that the accounts of a period do contain all the expenses and gains properly attributable to that period, all or some of the following adjustments will usually be required—

(*a*) Carry forward of payments in advance, e.g. Insurance, Rates, and in certain circumstances, Advertising (pages 65–9).

(*b*) Charges for accrued or accruing expenses, e.g. Rent, Heating, Lighting, Telephone (pages 69–71).

(*c*) Carry forward of income received but only PARTLY earned or accrued, e.g. Apprenticeship Premiums, Rents Received in Advance: and its converse, entries for income earned or accrued, not yet wholly received (pages 71–3).

(*d*) Incorporation of stock into the accounts, e.g. Stationery Stock.

(*e*) (1) Depreciation (pages 74–7).

(2) Bad and Doubtful Debts and Discounts (pages 77–81).

(*f*) Transfers—

(1) Correction of errors of commission, as, for instance, correction of posting to (i) wrong account, (ii) wrong side of an account, e.g. charging private withdrawals to Expenses Accounts.

(2) Correction of errors of omission, e.g. omission of returns, etc.

(3) (i) Special or abnormal charges against Profit and Loss Account.

(ii) Appropriations of Profits, e.g. commissions based upon profits.

(*a*) **Expenses Prepaid.** The book-keeping entry required to deal with prepayments or payments in advance is: debit Expenses

Prepaid Account, credit Expense Account; and the effect of the entry is to reduce the expenses debited to Profit and Loss Account. The Expenses Prepaid Account is an asset and will appear on the Balance Sheet as such.

Illustration. A commenced business on 1st April, 19.., and at the date of the Trial Balance extracted on 31st December, 19.., has paid rates to 31st March next, the proportion of such prepayment, i.e. for the three months between 1st January and 31st March, being £30. Make the adjustment for the purpose of preparing final accounts in respect of the period ended 31st December, 19...

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19..		£	£
Dec. 31	Expenses Prepaid . . . . . . *Dr.*	30	
	To Rates		30
	Being transfer of Rates prepaid at this date.		

The item will be shown in the Balance Sheet at 31st December, 19.., as an asset, and on the following 1st January, 19.., it will be transferred back to Rates Account, thus throwing the charge therefor on to the following period.

This entry will be—

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19..		£	£
Jan. 1	Rates . . . . *Dr.*	30	
	To Expenses Prepaid		30
	Being transfer of Rates applicable to three months ended 31st March, 19..		

The Ledger Accounts will then be—

Dr. RATES *Cr.*

19			£	19			£
Oct. 3 (say)	To Cash .		120	Dec 31	By Expenses Prepaid		30
					„ Profit and Loss Account . .		90
			£120				£120
19 . Jan. 1	To Expenses Prepaid		30				

Dr. EXPENSES PREPAID *Cr.*

19 .			£	19			£
Dec 31	To Rates Prepaid[1] .		30	Jan. 1	By Rates .		30

[1] This would appear in the Balance Sheet on 31st December, 19.., as an asset, and on the following 1st January, the first day in the new period, be re-transferred to Rates Account.

The same procedure will be followed in *all* cases of prepayments.

In practice, a simpler alternative method is generally adopted, whereby the adjustments are made within the one account. The method is as follows—

The amount prepaid is credited to the Expense Account and brought down as a balance on the account (in the same way as a cash balance is brought down). The balance of the Expense Account is then transferred to the Trading and Profit and Loss Account. The amount brought down on the Expense Account is shown in the Balance Sheet as an asset.

Illustration. The facts in the preceding illustration may be shown thus—

Dr. RATES *Cr.*

19 Oct. 3 (say)	To Cash		£ 120	19.. Dec. 31	By Amount Prepaid „ Profit and Loss Account	c/d	£ 30 90
			£120				£120
19 . Jan 1	To Rates Prepaid	b/d	30				

It is important to see that the final balance transferred to Profit and Loss Account shows a consistent result, e.g. if rates are £30 prepaid, the rates for the whole year should be £120, and this can be seen with reference to the account for the following year, which will appear as follows—

Dr. RATES *Cr.*

19 . Jan 1 Oct. 3	To Rates Prepaid „ Cash	b/d	£ 30 120	19 . Dec 31	By Amount Prepaid „ Profit and Loss Account	c/d	£ 30 120
			£150				£150
19..[1] Jan 1	To Rates Prepaid	b/d	30				

The above assumes that the rates payable for the rating year to the following 31st March are unaltered.

In order to make the principle clear the following example is given relating to insurance, which is usually payable in advance.

Illustration. A commences business on 1st May, and draws up his accounts on 31st December. He has paid insurance £36 in respect of Fire on 15th May covering the year to the following 30th April. In the next year he increases his cover and the new premium is to be £48. Show how these matters would be dealt with in the accounts for the eight months ended 31st December, and for the next year ended 31st December. As the form required for the Journal is precisely as before, only the Ledger Accounts are given.

[1] Succeeding year.

First method (i.e. the employment of Expenses Prepaid Account).

Dr. INSURANCE *Cr.*

19.. May 15	To Cash—Insurance for year ended 30th April, 19.. . .		£ 36	19.. Dec. 31	By Expenses Prepaid Account . .		£ 12
					,, Profit and Loss Account . .		24
			£36				£36
19.. Jan. 1	To Expenses Prepaid Account . .		12	19.. Dec 31	By Expenses Prepaid Account . .		16
May 15	,, Cash—Insurance for year ended 30th April, 19.. .		48		,, Profit and Loss Account . .		44
			£60				£60
19.. Jan. 1	To Expenses Prepaid Account . .		16				

Dr. EXPENSES PREPAID *Cr.*

19.. Dec. 31	To Insurance Prepaid[1].		£ 12	19.. Jan. 1	By Insurance Account .		£ 12
19.. Dec. 31	To Insurance Prepaid[1].		16	19.. Jan. 1	By Insurance Account .		16

Second Method (i.e. the making of the adjustment within the Expense Account).

Dr. INSURANCE *Cr.*

19.. May 15	To Cash . . .		£ 36	19.. Dec. 31	By Amount Prepaid .	c/d	£ 12
					,, Profit and Loss Account . .		24
			£36				£36
19.. Jan. 1	To Insurance Prepaid[1].	b/d	12	19.. Dec. 31	By Amount Prepaid .	c/d	16
May 15	,, Cash . . .		48		,, Profit and Loss Account .		44
			£60				£60
19.. Jan. 1	To Insurance Prepaid[1].	b/d	16				

It will be observed that A has been insured in the first period for EIGHT months only (i.e. the period commencing 1st May, 19.., and ending 31st December, 19..), and as the Insurance is £36 per annum, it is equivalent to £3 monthly, therefore £3 × 8 should be the charge to Profit and Loss Account for the first period. As

[1] These items will appear in the respective Balance Sheets as assets.

regards the second period, A is insured for FOUR months (i.e. from the following 1st January to 30th April) at £3 a month, and for EIGHT months (i.e. from 1st May to 31st December) at £4 a month; the amount of Insurance chargeable to the Profit and Loss Account should be, therefore, £44 [i.e. £3 × 4 (£12) plus £4 × 8 (£32)].

If A ceased to carry on business on 1st May in the year next following, there would be no further payment for Insurance, and the item of £16 would be transferred to the Profit and Loss Account for the four months ended 30th April, which is four months' insurance at £4 per month, i.e. £16.

(*b*) **Expenses Accrued and Accruing.** The circumstances giving rise to adjustments under this heading are roughly the reverse to those relating to prepayments; that is to say, where an expense has been incurred, but not brought into the accounts. Where an expense has become a definite debt this is termed an accru**ED** expense, but where it has not become a definite debt it is designated an accru**ING** expense. The distinction from a legal point of view is important, but for the purpose of elementary adjustments is quite immaterial. In order that the student may thoroughly appreciate the difference, an example may be given in relation to Rent. If a tenant draws up his accounts to 31st January, 19.., and has not paid his rent since the September quarter (29th September) then his Rent ACCRUED is for the quarter to 25th December, 19.., and his Rent ACCRUING is from that date to 31st January, 19... Both must be dealt with in the accounts because the business has had the use of the premises for such period, but in point of law it is the accrued portion that actually constitutes a definitely enforceable debt, and the accruing rent will not become ACCRUED rent, and therefore an enforceable debt, till 25th March, 19..; nevertheless both, as mentioned, must be the subject of a provision for Rent accrued and accruing in respect of the period ended 31st January.

Illustration. A draws up his accounts to 31st December, 19.., and his Rent is £180 per annum payable on the usual quarter days,[1] the last Rent being paid to 29th September, 19...

At 31st December, 19.., there is

	£
(*a*) Rent accrued to 25th December, 19.. . . .	45
(*b*) Rent accruing from 26th December, 19.., to 31st December, 19.., i.e. 6 days, i.e. 6/90 × £45 .	3

The amount to be provided therefore is £48.

The methods adopted for accruals will be founded upon the same principles as those adopted in dealing with prepayments; that is,

[1] The usual quarter days are 25th March (Lady Day), 24th June (Midsummer Day), 29th September (Michaelmas), 25th December (Christmas).

a separate Accruals Account may be opened or the adjustment may be made within the Expense Account itself.

First Method. The Journal entry will be—

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		£	£
19.. Dec. 31	Rent . . . . *Dr.*	48	
	To Expenses Accruals		48
	Being transfer of Rent accrued and accruing at this date.		
19..[1] Jan. 1	Expenses Accruals . . . . . . *Dr.*	48	
	To Rent		48
	Being transfer of Rent accrued and accruing at this date.		

Second Method. The amount accrued or accruing is debited to the Expense Account and brought down as a balance on the account, whereupon the balance of the Expense Account is transferred in the ordinary way to the debit of Profit and Loss Account. The amount brought down on the credit side of the Expense Account is shown in the Balance Sheet as a liability.

Illustration. A started business on 1st January, 19.., and draws up his first accounts in respect of the year to 31st December, 19... At this date he had not received the account in respect of his Gas and Electricity for the quarter ended 31st December 19... This account is estimated to be £30. The charges incurred for the first three quarters were—

	£
Quarter ended 31st March . .	25
,, ,, 30th June . .	20
,, ,, 30th September .	15

The journal entries to record the creation of this provision and the subsequent transfer to Profit and Loss Account are as follows—

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			£	£
19.. Dec. 31	Electricity and Gas . . . . . . *Dr.*		30	
	To Expenses Accrued			30
	Being amount accrued due and unpaid.			
	Profit and Loss Account . . . . . *Dr.*		90	
	To Electricity and Gas.			90
	Being transfer to Profit and Loss Account of amount applicable to the year ended this date.			

[1] Succeeding year.

The accounts will therefore be as follows—

Dr. ELECTRICITY AND GAS *Cr.*

19..			£	19 .			£
Mar. 31	To Cash		25	Dec 31	By Profit and Loss Account		90
June 30	" "		20				
Sept. 30	" "		15				
Dec. 31	" Expenses Accrued[1]		30				
			£90				£90

Dr. EXPENSES ACCRUED *Cr.*

				19 .			£
				Dec. 31	By Electricity and Gas[2]		30

In dealing with accruals, the student should be aware that if an Expenses Day Book is employed all expenses ACCRUED will have been passed through the books and if the account, at the date of the completion of the accounting period, is still unpaid, it will appear as a creditor so that provision is required only for items ACCRUING. On the other hand, if no such book is employed, the expenses being entered upon payment direct from the Cash Book, then all expenses *unpaid* whether accrued or accruing must be provided for. In other words, in *all* cases, "accruings" will require to be brought into the adjustments, but not "accrueds" where the invoice has already been passed through the books.

Care, however, must be exercised in obtaining all invoices for accrued items even if a Day Book is employed, particularly where time must elapse before the invoice is received, e.g. Electricity Account. The meter may be read to "6th December" and the accounts of the consumer be drawn up to 10th December. At this date it is improbable that the invoice for the quarter to 6th December will have been received. The Expenses Day Book might be kept "open" till its receipt but, if it is closed off promptly, provision will be required for (*a*) Electricity accrued to 6th December, and (*b*) Electricity accruing from 7th December to 10th December. If no Expenses Day Book is employed, the entries not being recorded till payment (neither of the above having been paid) both (*a*) and (*b*) will have to be provided for.

The above distinction, it should be emphasized, applies to all expenses.

(*c*) (i) **Unearned Income.** Where sums have been received during a period in respect of future service, only part of such sums will be applicable to service rendered in the period of accounts during which they were received. The part apportionable to future periods will be treated similarly to an "accrued" expense. A debit entry above

[1] Alternatively, the balance could be brought down below the line in the same account, thus dispensing with the Expenses Accrued Account.

[2] This amount is shown as a liability on the Balance Sheet drawn up at 31st December.

the line and a credit entry below the line in the income account will ensure that the Profit and Loss Account is credited with the correctly apportionable amount. The credit balance will appear as a liability in the Balance Sheet.

Illustration. A solicitor receives £300 premium from an articled clerk on 1st January, 19.., entering into articles for five years. The solicitor makes up his accounts for the year to 31st December, 19...

The "Premiums on Articled Clerks" Account will appear—

Dr. PREMIUMS ON ARTICLED CLERKS *Cr.*

19..			£	19..			£
Dec. 31	To Profit and Loss Account		60	Jan. 1	By Cash		300
	" Balance	c/d	240				
			£300				£300
				19..			
				Jan. 1	By Balance	b/d	240

(ii) **Income Accrued and Accruing.** The principle involved under this heading is analogous to that of expenses accrued or accruing except that the adjustment will operate in the reverse manner. The accrual for expenses, it will be remembered, has the effect of increasing the charge to the Profit and Loss Account and increasing the liabilities. The effect, therefore, of the adjustment now under consideration is to increase the income in the Profit and Loss Account, and increase the amount of the assets.

The rule is: Credit above the "line"; debit below the "line."

Illustration. The amount standing to the credit of Loan Interest at 31st December, 1952, is £100; an amount of £30 is *due* and unpaid by a borrower to 30th November, 1952, and £6 accruing.

Show Journal entries (ignoring narratives).

JOURNAL

1952			£	£
Dec. 31	Loan Interest Accrued and Accruing *Dr.*		36	
	To Loan Interest			36

Alternatively, the simple device of crediting above the "line" and debiting below the "line" may be, and usually is, adopted. The Ledger account is shown on page 73.

In examination work the precise words used in the Trial Balance should be carefully scrutinized because if the words "Loan Interest RECEIVED" are employed, the accrued and accruing amounts given in the question are *not* part of the balancing figures; if, on the other hand, the words "Loan Interest RECEIVED AND ACCRUED (and/or ACCRUING)" are employed, the account has already been adjusted

and the accrual is a DEBIT in the books; hence it is part of the Trial Balance, calling for no further adjustment. In the former instance, where the loan interest shown is only the amount received, the adjustment must be made.

Dr. LOAN INTEREST *Cr.*

			£				£
1952 Dec. 31	To Profit and Loss Account . .		136	1952 Dec. 31	By (details) . . .		100
					" Loan Interest Accrued to 30th Nov., 1952 .	c/d	30
					" Loan Interest Accruing . . .	c/d	6
			£136				£136
1953 Jan. 1	To Loan Interest Accrued	b/d	30	(a)			
	" Loan Interest Accruing . . .	b/d	6	(a)			

(a) Shown as an asset in the Balance Sheet.

(*d*) **Expenses Stock.** When stock is held other than of goods for resale, e.g. advertising or stationery stock, it should always be dealt with in the account to which it relates. It will therefore be included in the particular expense figure in the Profit and Loss Account and *not* in the stock of goods figure in the Trading Account. Thus, if the Trial Balance shows—

	£
Opening Stock (Stationery)	100
Stationery Purchases .	470

and as a note (not in the Trial Balance) closing stock of £70, the Profit and Loss Account will show a net debit of £500, i.e. £100 + £470 – £70, and the Balance Sheet, Stationery Stock £70 as an asset. If the closing stock is shown as part of the Trial Balance it presupposes that the Stationery Account has been fully dealt with, and in reference to the preceding illustration the Trial Balance would in these circumstances show—

	£	
Stationery Account . . .	500	(Profit and Loss Account)
Stationery Stock (Closing) . .	70	(Balance Sheet)

In the Expense Account itself, the entries for stock will be a credit "above the line" and a debit "below the line," thus—

Dr. STATIONERY *Cr.*

			£				£
19.. Jan. 1	To Stock .	b/d	100	19 . Dec. 31	By Stock .	c/d	70
Dec. 31	" Purchases		470		" Profit and Loss A/c .		500
			£570				£570
19.. Jan. 1	To Stock .	b/d	70[1]				

[1] Shown as an Asset in the Balance Sheet.

(*e*) (i) **Depreciation.** In normal circumstances the question of providing for depreciation is deferred until the Trial Balance is extracted and hence will not have been dealt with prior to the preparation of the final accounts. In examination work a note will be appended to the question stating the rate of depreciation to be provided. As the purpose at present is to explain the methods of entry of adjustments, detailed consideration of depreciation is dealt with in Chapter VII, but in order to present the student with a rough conception of its nature, it may be stated that depreciation is the inherent decline in the value of an asset from any cause whatever. The wearing out of a machine is a simple and obvious example, but it must be emphasized that this is but one of many causes. As with all other entries, there must be complete double-entry for the depreciation adjustment. The required entry is: debit Trading and Profit and Loss Account and credit the Asset, in respect of which depreciation is being recorded. This entry conforms with the principles already enunciated in that the debit to Trading and Profit and Loss Account is necessary because the amount written off represents an expense and the credit to the asset is required as the asset has, *pro tanto*, been reduced in value.

As there are usually several assets which must be treated in a similar manner it is not unusual to make the transfer for depreciation to a Depreciation Account and transfer the whole of that account representing the depreciation of several assets to the Trading and Profit and Loss Account.

The following would be the Journal entries for Depreciation, assuming that an amount of £100 is to be written off Plant.

JOURNAL

		£	£
19.. Dec. 31	Trading and Profit and Loss Account *Dr*	100	
	To Plant		100
	Being Depreciation for the year ended this date.		

If the Depreciation Account is employed in preference to the direct transfer as above, the entries would be—

JOURNAL

		£	£
19.. Dec. 31	Depreciation . . . . *Dr*	100	
	To Plant		100
	Being Depreciation for the year ended this date.		
	Trading and Profit and Loss Account[1] *Dr*	100	
	To Depreciation		100
	Being Depreciation transferred		

[1] See page 75 (end of first paragraph).

Depreciation dealt with before extracting the Trial Balance will appear among the accounts therein. The asset will already have been credited with the amount of depreciation and the necessary debit to depreciation made, so that only the formal transfer to Trading and Profit and Loss Account is required. Reverting to the above example the only entry required will be that marked (1).

These points may be further illustrated by an example—

Illustration. Fixtures Account at 1st January, 19. ., appears in the books at £500 and 5 per cent Depreciation is to be written off. If no depreciation has been written off for the year prior to the extraction of the Trial Balance, the amount standing in the books against Fixtures of £500 will appear in the Trial Balance at 31st December, 19. . . In order to write off depreciation an entry to the debit of Trading and Profit and Loss Account and to the credit of Fixtures Account will be required; or, the depreciation may be first debited to Depreciation Account and credited to Fixtures, and then transferred to the Trading and Profit and Loss Account.

On the other hand, if depreciation has been dealt with ***prior*** to the extraction of the Trial Balance, the Trial Balance will not show Fixtures Account as £500 (for £25 has already been credited to it by way of depreciation), but as £475, and Depreciation Account will be part of the Trial Balance at the figure of £25. Hence, instead of Fixtures £500 there will be Fixtures £475 and Depreciation Account £25. Upon preparing the Trading and Profit and Loss Account the amount of £25 debited in the Depreciation Account will be transferred to the former account by the following entry: debit Trading and Profit and Loss Account, credit Depreciation Account.

If the asset is to stay in the books at cost, the entries are—

Debit Depreciation Account (or Profit and Loss Account).

Credit Depreciation Provision or Fund Account.[1]

Where cash is invested outside the business to ensure that when replacement is required, the necessary CASH will be available, the following additional entries will be made—

Debit Depreciation Investment Fund.

Credit Bank.

Depreciation is usually computed at a certain rate per annum, e.g. 10 per cent per annum. The student must exercise great care in the calculation, when the period covered by the accounts is not a year, for when the accounts are prepared half-yearly the depreciation would be 5 per cent actual. Examiners often omit the term "per annum," so that if the *actual* rate is given, the amount to be calculated for depreciation will require adjusting accordingly. For

[1] This may also be referred to as "Depreciation Reserve." The difference between the terms Provision and Reserve is dealt with in Chapter VII. The distinction is important in Limited Company accounts, but the student may find it useful to accustom himself to the terms by using them also in the accounts of sole traders and partnerships.

example, if accounts are prepared half-yearly, depreciation at 15 per cent per annum will mean 7½ per cent for the half year; but if the words "per annum" are omitted, depreciation in that half-year will be 15 per cent instead of 7½ per cent, that is at the rate of 30 per cent per annum.

Where assets have been acquired during the period covered by the accounts, depreciation should be charged upon the new assets from the date of acquisition to the end of the accounting period. In the examination, if no indication is given as to the date of acquisition, depreciation should be calculated on the closing balance, and an explanatory note made at the foot of the answer. The newly acquired asset may be an ADDITION to the existing assets, or may be merely a REPLACEMENT. In the latter case the book value of the old asset must be completely eliminated by crediting it with—

(*a*) Loss on Sale (if a profit the entry will be a debit).
(*b*) Depreciation to the date the asset ceases to be used.
(*c*) Proceeds of Sale.

If any costs should be incurred, for example on dismantling plant, these also will appear as a debit to the old Asset Account. Thus—

Dr. PLANT *Cr.*

			£			£
	To Balance . . .	b/d	150		By Sale	10
	,, Cost of Dismantling .		22		,, Depreciation (to date of ceasing to be used) .	20
					,, Profit and Loss Account (Loss on Sale) . . .	142
			£172			£172

If the sale realized, say, £210 the account would be—

Dr. PLANT *Cr.*

			£			£
	To Balance . . .	b/d	150		By Sale	210
	,, Cost of Dismantling .		22		,, Depreciation . .	20
	,, Profit and Loss Account (Profit on Sale) . . .		58			
			£230			£230

Illustration. Period of accounts 1st June, 19.. to 31st December, 19.. (i.e. **seven months**).

	£
Plant and Machinery Balance, 1st June, 19.. .	8,000
Plant and Machinery purchased 1st October, 19.. .	2,000

Depreciation to be calculated at 6 per cent per annum.

The amount of depreciation is—

	£
6% on £8,000 for 7 months	280
6% on £2,000 for 3 months	30
	£310

[6% per annum = 1s. per £10 per month.]

Plant and Machinery Account will appear as follows—

Dr. PLANT AND MACHINERY *Cr.*

19..			£	19..			£
June 1	To Balance	b/d	8,000	Dec. 31	By Depreciation .		310
Oct. 1	,, Cash (or Creditor)		2,000		,, Balance	c/d	9,690
			£10,000				£10,000
19..							
Jan. 1	To Balance	b/d	9,690				

Depreciation is dealt with in more detail in Chapter VII.

(ii) **Provisions[1] for Bad and Doubtful Debts and Discounts.** The provision for bad and doubtful debts is usually made by taking a suitable percentage on Sundry Debtors[2] and when computed the amount will be entered **twice** in the Bad and Doubtful Debts Account—

(1) On the debit side above the "line," and
(2) On the credit side below the "line."

The latter figure will be shown either as a liability, or as a *deduction from* Debtors on the assets side of the Balance Sheet. The latter method is more frequently used in modern accounting.

Where separate accounts for Bad Debts and Provision for Bad and Doubtful Debts are kept, and it is required to carry forward to the next period a revised provision based upon a percentage of Sundry Debtors, the following steps must be taken—

(1) The balance of Bad Debts Account, that is bad debts actually WRITTEN OFF, less bad debts that have been recouped, is transferred to the debit of Provision for Bad and Doubtful Debts, or to the credit of that account if recoveries exceed amounts written off.

(2) The new Bad and Doubtful Debts Provision will be debited above the "line" and credited below it in the Provision Account.

(3) The balance will be dealt with thus—

(*a*) if DEBIT, the transfer will be—Debit Profit and Loss Account and Credit Provision for Bad and Doubtful Debts.

(*b*) if CREDIT, the transfer will be—Debit Provision for Bad and Doubtful Debts and Credit Profit and Loss Account.

Illustration. The following figures relate to the books of a trader.

Bad and Doubtful Debts Provision at 1st January, 19.. . . *Cr.* £800
Bad debts written off during the year to 31st December 19.. *Dr.* £900

The Provision is to be maintained at 5 per cent of Sundry Debtors, which at 31st December, 19.., are £20,000.

[1] These may also be referred to as Reserves instead of Provisions. See footnote on page 75.

[2] Alternatively the Bad and Doubtful Debts Provision may be based on an estimate of the worth of each debt at the balance sheet date or be taken as a percentage on *credit* sales. (Usually the former is preferred, as it is more accurate, and being specific, will be allowed for taxation purposes.)

The Bad and Doubtful Debts Provision will be—

Dr PROVISION FOR BAD AND DOUBTFUL DEBTS *Cr*

19 Dec 31	To Bad Debts written off		£ 900	19 Jan 1	By Balance	b/d	£ 800
	,, Balance	c/d	1,000	Dec 31	,, Profit and Loss Account		1,100
			£1,900				£1,900
				19 Jan 1	By Balance	b/d	1,000

Dr BAD DEBTS *Cr*

19 Dec 31	To Debtors (detailed)		£ 900	19 Dec 31	By Transfer to Provision for Bad and Doubtful Debts		£ 900

It will be apparent that the "clearance" may be effected by transferring *from* Bad Debts Provision *to* Bad Debts Account and to this alternative no objection can legitimately be raised Eliminating dates the accounts would appear—

Dr PROVISION FOR BAD AND DOUBTFUL DEBTS *Cr*

	To Balance	c/d	£ 1,000		By Balance	b/d	£ 800
					,, Transfer to Bad Debts Account		200
			£1,000				£1,000
					By Balance	b/d	1,000

Dr BAD DEBTS *Cr*

	To Debtors (detailed)		£ 900		By Profit and Loss Account		£ 1,100
	,, Transfer from Bad and Doubtful Debts Provision		200				
			£1,100				£1,100

Alternative Treatment of Bad Debts. A consolidated account is often used whereby the provision is raised and adjusted in the Bad Debts Account, thus dispensing with the separate account, as below—

Dr BAD DEBTS *Cr.*

	To (details, etc)		£ 900		By Provision	b/d	£ 800
	,, Provision	c/d	1,000		,, Profit and Loss Account		1,100
			£1,900				£1,900
					By Provision	b/d	1,000

Discounts. Where a Provision for Discounts is to be created on Sundry Debtors, the object is to charge against the current period

the estimated cash discounts that will be ordinarily allowed to debtors on sales during the period, and which will involve a reduction in the Balance Sheet of the book value of debtors. Naturally, such a discount will be allowed only upon payment being made within the period stipulated expressly or impliedly in the contract, so that it is **usually not necessary to provide for discounts on all the debtors,** and further it is clear that if a debtor's account is written off as bad no provision for discount is required. It is therefore important that the discount provision be calculated on the proportion of debtors likely to be "good," that is, not merely those who will pay "sooner or later" but the prompt payers. As a matter of caution, it is the practice generally to assume that the proportion of debtors who are likely to pay will pay promptly and take advantage of the discount terms. **Therefore, before making the Discount Provision the estimate of bad and doubtful debts must FIRST be made and provided for, and the Discount Provision created on the *balance* of debtors; in other words, on the estimated "good" debtors, being the debtors according to the ledger less the Provision for Bad and Doubtful Debts.**[1]

It is usual to confine the creation and adjustment of the *Discount* Provision to the last method shown in relation to bad debts, i.e. the consolidated account.

Illustration.

	£
Discounts allowed during the year to 31st December, 19 . .	1,200
Discount Provision at 1st January, 19	270
Debtors (none likely to be bad) at 31st December, 19 . .	6,000
Discount Provision to be 5%.	

Dr. DISCOUNTS ALLOWED *Cr.*

			£				£
19 Dec 31	To Sundries from Cash Book . . .		1,200	19 . Jan. 1	By Provision . .	b/d	270
	,, Provision . .	c/d	300	Dec. 31	,, Profit and Loss Account .		1,230
			£1,500				£1,500
				19. Jan. 1	By Provision . .	b/d	300

If, however, it is estimated that 20 per cent of the £6,000 are likely to be bad, the Bad and Doubtful Debts Provision would be adjusted to £1,200, leaving £4,800 as the BASIS of the Discount Provision; so that the Provision of £300 as computed above would be 5 per cent of £4,800 = £240, the account being as follows—

Dr. DISCOUNTS ALLOWED *Cr.*

			£				£
19 Dec. 31	To Sundries from Cash Book . . .		1,200	19 . Jan. 1	By Provision . . .	b/d	270
	,, Provision . .	c/d	240	Dec. 31	,, Profit and Loss Account . .		1,170
			£1,440				£1,440
				19 Jan. 1	By Provision . . .	b/d	240

[1] The same principle must be followed in respect of Goods out on Sale or Return (see page 85).

The Balance Sheet at 31st December, 19.., would, as far as Debtors are concerned, appear—

	£	£
Sundry Debtors	6,000	
Less Provision for Bad and Doubtful Debts [1] (20%)	1,200	
	4,800	
Less Provision for Discounts [1] (5% of £4,800) .	240	
		4,560

Illustration. The following figures appear in the books of Y—

19 .		£
Jan. 1.	Bad and Doubtful Debts Provision . .	1,200
	Discounts Allowed Provision . . .	560
Dec. 31.	Discounts Allowed during year . . .	930
	Bad Debts written off	470
	Bad Debts recovered.	25
	Debtors (per Ledger)	10,060

Write off a further £240 (definitely bad).
Create a Discounts Allowed Provision of 3 per cent
Create a Bad and Doubtful Debts Provision of 10 per cent. Show Accounts: calculate to nearest £

The accounts are—

Dr PROVISION FOR BAD AND DOUBTFUL DEBTS *Cr*

19			£	19			£
Dec 31	To Balance . . .	c/d	982	Jan 1	By Balance . . .	b/d	1,200
	„ Bad Debts		218				
			£1,200				£1,200
				19 Jan 1	By Balance .	b/d	982

Dr. BAD DEBTS *Cr.*

19			£	19			£
Dec 31	To (details) . .		470	Dec 31	By (details) Bad Debts Recovered [2] .		25
	„ Sundry Debtors written off .		240		„ Bad Debts Provision .		218
	„ Profit and Loss Account .		25		„ Profit and Loss Account .		492
			£735				£735

Dr. DISCOUNTS ALLOWED *Cr.*

19			£	19			£
Dec 31	To Sundries		930	Jan 1	By Provision . . .	b/d	560
	„ Provision . .	c/d	265	Dec 31	„ Profit and Loss Account . .		635
			£1,195				£1,195
				19 Jan 1	By Provision . .	b/d	265

[1] These items are CREDITS in the books, and instead of being shown as liabilities are DEDUCTED from the asset.
[2] The debit is to cash; or alternatively the treatment is—
Debit cash; Credit Personal Account.
Debit Personal Account; Credit Bad Debts Account.

Dr. SUNDRY DEBTORS *Cr.*

			£				£
19.. Dec. 31	To (detailed Ledger Accounts) . . .		10,060	19.. Dec. 31	By Bad Debts . .		240
					" Balances . . .	c/d	9,820
			£10,060				£10,060
19.. Jan. 1	To Balances . . .	b/d	9,820				

Notes. (1) The Bad and Doubtful Debts Provision would be created on the value of the debtors as shown in the books at 31st December, 19.., i.e. 10% of £9,820.

(2) The Discount Provision is 3% on—

	£
Book Value of the Debtors . . .	9,820
Less Bad and Doubtful Debts Provision	982
	£8,838
∴ 3% on £8,838 (taken to nearest £) =	£265

These Provisions will then appear in the Balance Sheet in the following manner—

ASSETS SIDE

	£	£
Sundry Debtors	9,820	
Less Provision for Bad and Doubtful Debts (10%)	982	
	8,838	
Less Provision for Discounts (3% of £8,838) .	265	
		8,573

Loan Interest. The lender of money usually requires a reward for the use by the borrower of the sum loaned, the amount of which varies with circumstances. Such a reward is termed Interest and it is customary in normal circumstances to stipulate for the payment of loan interest at stated periods, yearly or half-yearly. Hence, if accounts are drawn up at a date other than that of the due date of the payment of the loan interest (assuming that the borrower pays promptly), an adjustment is required to cover the loan interest accruing since the last due date.

The same principle applies in connexion with other expenses, viz. that a charge may be required in respect of an amount ACCRUED (unless this should happen to be paid on the due date) and an amount ACCRUING in respect of the period elapsing from the due date of the loan interest and the date to which the accounts are made up.

Illustration. Trial Balance at 31st January, 19.., shows (*inter alia*):

	£
Loan Account (*Cr.*) **at 6% per annum** . .	100,000
Loan Interest (*Dr.*)	3,000

It is quite evident that, assuming the loan was made at least a year ago, there is accrued a half-year's interest and consequently the required adjustment is—

	£
Debit Loan Interest Account above the "line" .	3,000
Credit Loan Interest Account below the "line" .	3,000

The latter being a credit balance in the books will be shown in the Balance Sheet at 31st January, 19.., as a liability, either as a separate item or with the loan, thus—

	£	£
Loan Account	100,000	
Add **Interest to date** . . .	3,000	
		103,000

The Loan Interest of £6,000 for the year will be transferred in the usual way to the debit of Profit and Loss Account.

Illustration. A borrowed £5,000 on 30th April, 1951, agreeing to pay interest at the rate of 4 per cent per annum, on the 31st October and the 30th April in each year. He prepares his accounts yearly on 31st December. Show Loan Interest Account in A's books for the years ended 31st December, 1951, and 1952. It may be assumed that the payments are made promptly on the due dates.

Dr. LOAN INTEREST [1] *Cr.*

			£	s	d				£	s	d
1951 Oct. 31	To Cash: Half-year's Interest to date		100	0	0	1951 Dec 31	By Profit and Loss Account .		133	6	8
Dec 31	,, Interest accruing, 2 months	c/d	33	6	8						
			£133	6	8				£133	6	8
1952 Apl. 30	To Cash: Half-year's Interest to date		100	0	0	1952 Jan 1	By Interest accruing	b/d	33	6	8
Oct 31	,, Cash. do. .		100	0	0	Dec 31	,, Profit and Loss Account		200	0	0
Dec. 31	,, Interest accruing, 2 months	c/d	33	6	8						
			£233	6	8				£233	6	8
						1953 Jan 1	By Interest accruing	b/d	33	6	8

If in 1953 the borrower pays only the half-year's interest to 30th April, 1953, the half-yearly amount due on 31st October, 1953, being paid on 10th January, 1954, the account for 1953 and 1954 (assuming the 1954 payments are met promptly) would be—

[1] In practice, Income-tax is deducted from each payment of Interest. This does not affect the principle above outlined and treatment of Income-tax in this connection is dealt with in Chapter XXI.

Dr. LOAN INTEREST *Cr.*

			£	s.	d.				£	s.	d.
1953 Apl. 30	To Cash: Half-year's Interest to date		100	0	0	1953 Jan. 1	By Interest accruing .	b/d	33	6	8
Dec. 31	,, Half-year's Interest to 31st October, 1953, ACCRUED	c/d	100	0	0	Dec. 31	,, Profit and Loss Account . .		200	0	0
	,, Interest accruing, 2 months .	c/d	33	6	8						
			£233	6	8				£233	6	8
1954 Jan. 10	To Cash: Half-year's Interest to 31st Oct., 1953 .		100	0	0	1954 Jan. 1	By Half-year's Interest to 31st Oct., 1953, ACCRUED	b/d	100	0	0
Apl. 30	,, Cash: do. to date		100	0	0		,, Interest accruing .	b/d	33	6	8
Oct. 31	,, Cash: do. to date		100	0	0	Dec. 31	,, Profit and Loss Account . .		200	0	0
Dec. 31	,, Interest accruing, 2 months .	c/d	33	6	8						
			£333	6	8				£333	6	8
						1955 Jan. 1	By Interest accruing .	b/d	33	6	8

Where repayments of the loan itself have taken place it will be necessary to ascertain the date of repayment as the adjustment for loan interest accrued or accruing will be modified accordingly.

Illustration. Reverting to the preceding example, on 1st August, 1955, the borrower repays £1,000 and the interest payments are made promptly at due dates.

The calculation of the accrual at 31st December, 1955, will be thus —

Two months' Interest accruing on £4,000 at 4% per annum, viz. £26 13s. 4d.

Moreover, the Loan Interest paid 31st October, 1955, will be—

	£
Three months' Interest on £5,000 at 4% per annum, that is, for the period between 1st May, 1955, and 31st July, 1955 .	50
Three months' Interest on £4,000 at 4% per annum, that is, for the period between 1st August, 1955, and 31st October, 1955 .	40
Payment of Loan Interest on 31st October, 1955 .	£90

The account would be continued in 1955, as follows—

Dr. LOAN INTEREST *Cr.*

			£	s.	d.				£	s.	d.
1955 Apl 30	To Cash: Half-year's Interest to date		100	0	0	1955 Jan. 1	By Interest accruing .	b/d	33	6	8
Oct 31	,, Cash: do. . .		90	0	0	Dec. 31	,, Profit and Loss Account [1] .		183	6	8
Dec. 31	,, Interest accruing, 2 months .	c/d	26	13	4						
			£216	13	4				£216	13	4
						1956 Jan. 1	By Interest accruing .	b/d	26	13	4

[1] I.e. Interest for 7 months on £5,000 (£116 13s. 4d.) plus Interest for 5 months on £4,000 (£66 13s. 4d.) at 4 per cent per annum.

The repayment of the principal would be debited to the Loan Account.

In the books of the lender the entries will be exactly opposite to the above.

If an Expenses Day Book is used the interest *accrued* will have passed through the books; hence an adjustment is required only for items *accruing*.

(*f*) **Transfers.** As the correction of errors requires detailed treatment (see Chapter XIV) all that need be stated here is that the transfer required will conform to ordinary double-entry principles, a simple illustration sufficing for the present.

Illustration. An amount of £10 is paid for decorations to the private house of a trader, such amount being paid by cheque on the business banking account and debited to General Expenses. The correcting entries are—

	£
Debit Drawings (or Capital) Account . . .	10
Credit General Expenses	10

It is important also that abnormal or exceptional items or expenses should be shown quite clearly and separately in the accounts and not merged with normal items or expenses.

CONSIDERATION OF INDIVIDUAL ITEMS

There is no uniform practice as to which items should be included in the Trading and which in the Profit and Loss section of the final account. Each case must be considered on its own merits. In manufacturing concerns, a Manufacturing or Working Account is often employed either in addition to or instead of a Trading Account: these will be considered later in Chapter XXXII. In non-manufacturing concerns where goods are purchased for resale, and in manufacturing concerns where no separate Manufacturing or Working Account is prepared, the Trading Account should include only those expenses which are directly attributable to putting the goods in a saleable condition: all selling, distribution and overhead expenses will be included in the Profit and Loss Account. The most important point is that treatment must be consistent so that the rate of Gross Profit may be compared from one period to another.

(1) **Stock.** Opening and Closing Stock of goods held for sale will be included in the Trading Account as already described. It is important that these items be confined to stock of goods purchased for resale or for manufacturing into saleable condition. This will exclude the following—

(*a*) *Expenses Stock.* This has already been dealt with (see page 73).

(*b*) *Stock in Special Circumstances.* Goods which are in possession of the trader are not necessarily his property, e.g. they

may be goods received on sale or return, on consignment for sale, or as agent. The treatment will vary according to circumstances, but it may be stated as a general rule that unless the goods have been definitely purchased they should be excluded from the stock; and if they have been definitely purchased a corresponding entry will be, or ought to have been, made in the Purchases Account. Conversely, when goods have been bought and the seller dates forward the invoice (e.g. goods bought on 15th July, 19.., may be invoiced as on 15th August, 19..) the purchase should be duly recorded in July and the goods included in stock (unless sold), as such arrangement is merely one whereby the purchaser obtains extended credit.

Thus, the following goods must *not* be included in Stock—

(*a*) Goods held by the business as agent or consignee, or sold awaiting delivery to the purchaser.

(*b*) Goods held by the business as security.

(*c*) Goods out on Sale or Return, when the title thereto has passed to the sendee.

Conversely, the following *must* be included—

(*a*) Goods purchased and entered, including goods in transit or stored.

(*b*) Goods purchased and entered which are in the hands of agents and consignees, or held as security.

(*c*) Goods purchased and entered which are out on Sale or Return unless the title thereto has passed to the sendee. [If already entered out as Sales, an entry must be made to eliminate the sale, e.g. by debiting Sales and crediting Goods out on Sale or Return, the latter being deducted from Debtors in the Balance Sheet (see Chapter IX).]

(*d*) Goods at Branches, unless dealt with in separate Branch Accounts.

Stocktaking. Where practicable Stock should be taken on the expiry of the business accounting period. Often this is not possible and the actual stocktaking may have to be done during the last day of the year, or may extend into the next few succeeding days.

In many retail businesses the Stock is evaluated at the retail selling prices and reduced to cost by a deduction of the gross profit percentage on selling prices, otherwise the valuation will be at cost.

In all cases the necessary revision to market prices if lower than cost will be required.

The principles to be followed are—

(1) That the goods purchased and the invoices therefor are passed through the books in the same accounting period, so that the liability

is taken into account in the same accounting period as the appropriate asset.

(2) That where goods are sold, although not actually delivered, they should be included in the Sales but excluded from stock.

(3) That where goods, although not in its physical possession, belong to the business they must be included in Stock (and Rule 1 observed).

(4) Where Stocktaking takes place during the time sales are being effected, care must be taken to avoid inclusion of goods as Stock on hand and in the Cash (or Debtors), e.g. if a retailer takes Stock during, say, the last day of the year the Cash received in respect of goods taken into Stock must be reduced to Cost and deleted from Stock; if the Stocktaking takes place during the *day after* the close of the accounting period the whole of the takings for that day must be added to Stock either at cost, or, if evaluations are based on retail selling prices less percentage deduction, then the cash takings augment the Stock at selling price and the deduction is taken from the total.

Illustration. X's financial year ends on the last Wednesday in September, but actual stock is not taken until the following Saturday, when it is ascertained at £33,500. You find that—

(1) Sales are entered in the Sales Day Book on the same day as despatched, and Returns Inwards in the Returns Book the day the goods are received back.

(2) Purchases are entered in the Purchases Day Book as the invoices are received.

(3) Sales between the Wednesday and Saturday per Sales Day Book and Cash Sales Book were £1,720.

(4) Purchases between the Wednesday and Saturday per the Purchases Day Book were £120, but, of these, goods amounting to £40 were not received until after the stock was taken.

(5) Goods invoiced during September (prior to the last Wednesday) but not received until after the Wednesday amounted to £100 of which £70 worth were received between the Wednesday and Saturday.

(6) Goods sold in the previous week £60 were returned on the Monday but did not reach X until the Thursday.

(7) The rate of Gross Profit to Sales is 25%.

Ascertain the value of the stock as at the end of the financial year, assuming that the market value is higher than cost and that the Purchases and Sales Day Books are not to be amended.

CALCULATION OF STOCK VALUE AT LAST WEDNESDAY IN SEPTEMBER

	£	£
Stock (Saturday following)		33,500
Add Sales (Wednesday–Saturday)	1,720	
Less Gross Profit (25%)	430	
		1,290
		34,790
Less Purchases entered (Wednesday–Saturday) . .	120	
Less received after stocktaking	40	
		80
		34,710
Add Goods invoiced September prior to the last Wednesday not received until after stocktaking .		30
		34,740
Less Returns Inwards not entered in current financial period		45
Stock value at close of current financial period . .		£34,695

It will be observed that all the Day Book entries, except (6) (see below) had been made to the Wednesday when the year ended, so that no adjustments are required in the Ledgers.

As to (3), the addition to the stock is the goods sold since Wednesday to restore it to the position on that day.

As to (4), all these purchases relate to the *next* period, so that if any goods are received between Wednesday and Saturday they must be eliminated. This figure is £120 less £40 received *after* Saturday, i.e. £80.

As to (5), all these purchases belong to the financial period ended Wednesday, so that any "late" deliveries must be added to stock. Those actually delivered between Wednesday and Saturday will automatically have been taken into stock, i.e. £70; but those which have been delivered after Saturday, i.e. £30, are not included in stock and so must be added.

As to (6), the goods returned are included in stock at a cost price of £45, so that they are included both in Stock and Debtors. Stock should therefore be reduced by £45, but as the amount in the Debtors is still at the selling price of £60, a provision of £15 should be made. The better treatment, however, which can be effected without amending the Sales Day Book or the Returns Inwards Book is to—

(1) make no amendment to the stock figure, so that the deduction above of £45 would not be required; and

(2) adjust the Sales Account for the returned goods at selling price in the same way as making an entry for an accrual, thus—

Dr. SALES *Cr.*

		£			£
To Returns . . .			By Sales . . .		
,, Returns unentered .	c/d	60	,, Trading Account .		
	£			£	
			By Returns unentered .	b/d	60

The £60 would be deducted from the Debtors' total for Balance Sheet purposes. If the goods were returned by the purchaser on the Thursday, the deduction of £45 without any further adjustment would be correct.

Stock Valuation. The accepted rule is that closing Stock should be taken into account at Cost or Market Value, whichever is the lower. In this connection—

(1) *Cost* means the net price payable for goods, i.e. invoice price after deduction of trade discount and all allowances referable to the goods in question, e.g. allowances for defects. To this may be added direct and indirect expenses actually incurred, having regard to the stage of manufacture, condition or location of the goods, e.g. cost of transport, packing, mixing, breaking bulk, etc.

The calculation of cost may be based on—

(*a*) The ascertained cost of each item or batch (i.e. "Unit" cost).

(*b*) The average over a period of time.

(*c*) The goods represented by the latest purchases, on the "first in, first out" (FIFO) principle (or even, in certain circumstances, on the earliest purchases, following the "last in, first out" (LIFO) principle[1]).

These are generally the most common methods of calculating cost, being based on actual ascertained cost, i.e. on cost as an historical fact. Where this is not suitable on account of the nature of the business, an estimated figure is taken, either—

(i) on a budgeted cost per unit, particularly where the unit is manufactured in several processes, i.e. "Standard" cost, or

(ii) on adjusted selling prices, by deducting from such prices estimated selling expenses and the normal profit percentage.

(2) *Market price* means either—

(*a*) The buying price ruling at the end of the financial period, assuming a purchase is made in the usual way, that is, of normal quantities under ordinary conditions—in other words, replacement cost, or

(*b*) The estimated net selling price of the goods either in their existing condition or, after allowing for all expenditure still to be incurred, in their ultimate manufactured form.

Other methods of valuing stock which may be mentioned are—

(i) At the actual selling price subsequently received, less realization expenses (as with Tea, Rubber and Tin Companies).

(ii) The Base Stock method, where such stock is permanently retained at a fixed figure at or under original cost.

(iii) At a fair value to a going concern, calculated in a similar way to 2 (*b*) above; although not a very prudent method, it is advanced on the grounds that, in a (say) manufacturing concern, the benefit of effort should go to the period in which the effort was made.

In all cases due regard must be had to the condition and location of the goods and to market conditions generally.

[1] The LIFO method is not in common use and is generally not accepted for taxation purposes, but see the 1952 Canadian case of *Anaconda American Brass, Ltd.* v. *Minister of National Revenue*.

No one method is suitable or practicable for all types of business. In normal circumstances, however, stock is a current asset intended to be held for the minimum length of time prior to realization and therefore the usual basis of valuation should be the lower of cost or market value, the former being calculated on whichever of the above bases will give a fair view of the trend of results, the latter preferably as described in 2 (*b*). If less than 2 (*b*), 2 (*a*) may be used, in which case the Balance Sheet should show that the valuation is "at the lower of cost or replacement value." Where, on account of the nature of the business, any other method of stock valuation is used —as, for example, in the case of Tea, etc., companies as mentioned above—the fact should be stated in the Balance Sheet. Whatever method is adopted, however, it should be employed *consistently*.

In dealing with the application of the "lower of cost or market value" rule, there are two methods (to be applied consistently)—

(1) To list all the Stock and obtain the aggregate cost and aggregate market value, taking the lower total into the final accounts, or

(2) To take each item or batch at the lower of cost or market value.[1]

Illustration.

STOCK LIST

Item	*Cost Price*	*Market Price*
	£	£
1 . .	*40*	55
2 . .	62	*23*
3 . .	*131*	137
	etc.	*etc.*
	£233	£215

Under (1), the amount shown in the Market Price column would be taken as the valuation. Under (2), the value would be £194 (composed of each "lower" item, shown above in italics).

The following points may also be noted—

(*a*) Where the cost of stocks of by-products cannot be ascertained, they should be valued at current net selling price, the cost of the main product being reduced accordingly.

(*b*) Where forward purchases are not covered by forward sales, provision should be made when necessary to reduce the cost to market value. Conversely, where forward sales are not covered by forward purchases or stocks, provision should be made where necessary to cover the excess over the sales value of anticipated cost.

[1] This method was approved for tax purposes in *C.I.R.* v. *Cock, Russell & Co., Ltd.*, and *Worthington* v. *Oceana Development Co., Ltd.*, when it was proved that it was the normal commercial practice.

(c) Any deduction to reduce stock value below the appropriate level described above is a reserve and should be shown as such in the Balance Sheet.

(2) **Purchases.** Goods purchased for sale, whether immediate or ultimate, are included under this heading. Returns Outward will be shown as a deduction from the Purchases Account, and it is of little consequence whether the Returns Outward are recorded in a Returns Outward Account and transferred separately to the Trading Account, or transferred to the Purchases Account and the net balance only of the latter account transferred to the Trading Account, so long as the Trading Account correctly discloses the net purchases.

The following adjustments are usually required in reference to purchases (if the latter includes purchases of goods otherwise than for sale)—

(1) *Purchases of fixtures, plant and other assets.* The adjusting entry is: debit Fixtures (or other assets), credit Purchases Account.

(2) *Purchases of goods for private use.* The adjusting entry is: debit Capital or Drawings Account, credit Purchases Account.

(3) *Purchases of stationery, advertising materials, and other "Expense" stock.* Unless it has been separately recorded either by means of an Expenses Day Book or a separate column in the Purchases Day Book, a transfer is necessary as follows—

Debit Stationery Account (or other expense item); credit Purchases Account.

Where the balances have been extracted and it is discovered that certain items of purchases have not been entered, it is usual to ascertain the total of such items and to pass an entry through on lines similar to those called for by an "accrual item," i.e. debit above the "line," credit below the "line." The former entry will augment the Purchases Account, and the latter will represent creditors and will be shown as such in the Balance Sheet. The detailed purchase items will be passed through the books on the first day of the new period.

Returns outward will be dealt with conversely.

Illustration. In the Trial Balance on 31st December, 19.., appear—

	Dr.	Cr.
	£	£
Creditors		4,000
Purchases	12,000	

It is discovered after balancing off the books and preparing the Trial Balance that items to the sum of £500 have been omitted from the Purchases Day Book. The adjustment will be as shown on page 91.

Dr. PURCHASES *Cr.*

19.. Dec. 31	To Sundries (as per Trial Balance) . .		£ 12,000	19.. Dec. 31	By Trading Account		£ 12,500
	" Purchases omitted from Purchases Day Book . .	c/d	500				
			£12,500				£12,500
				19.. Jan. 1	By Purchases omitted .	b/d	500

The Balance Sheet will show Creditors—

	£	£
Per Ledger	4,000	
" Purchases Account . . .	500	
		4,500

(3) **Carriage.** It is customary to charge carriage inwards (i.e. carriage of goods purchased) to the Trading Account, and carriage outwards (i.e. carriage of goods sold) to the Profit and Loss Account. If the item represents an expense not connected with purchases or sales a transfer is required to the appropriate account; e.g. if carriage inwards includes carriage in respect of new fittings, an adjusting entry is made thus—

Debit Fittings Account; credit Carriage Inwards Account.

(4) **Wages.**[1] For the purpose of convenience, salaries will be dealt with hereunder. The terms are generally distinguished by their method of computation (i.e. a wage is calculated or paid in reference to a week, a salary to a month or year), but this distinction does not necessarily form the true criterion of the work performed.

Only those wages should be included in the Trading Account which are directly attributable to the purchase or production of goods for resale; selling, distribution, etc., wages are included in the Profit and Loss Account.

The following points should be considered—

(*a*) **Wages and salaries, if incurred other than for the ordinary purposes of the business,** should be transferred to the account to which they really relate, e.g. wages paid to workmen, (*a*) for repairs, (*b*) for construction of a machine, (*c*) for private purposes. These should be transferred to (*a*) Repairs, (*b*) Machinery Account, and (*c*) Proprietor's Capital or Drawings Account, unless the business is that of executing repairs or constructing machinery and such work is done for customers.

(*b*) **Where employees,** owing to the nature of the employment, **are housed, fed and/or clothed** (as at a Club, Hotel or Hospital) a transfer should be made to the debit of Wages Account from the account to which the expense has in the first instance been debited. In many cases no entry whatever will have been made and hence an estimated figure will be taken and the result incorporated in the accounts; e.g.

[1] See footnote on page 57.

for meals of waiters: credit Provisions or Meals Account; debit Wages Account, unless it is desired to keep separate accounts for Staff Meals, etc.

(*c*) **Where wages or salaries are stated at a rate "free of Income Tax,"** i.e. the employer pays the tax on behalf of the employee, the net amount payable to the employee must be "grossed up" and it is this latter amount which must be debited to Wages Account. Such payments come under the system of P.A.Y.E. which is dealt with in Chapter IX where a detailed illustration will be found.

(*d*) **Wages accruing** should be provided for.

(*e*) **Where wages are shown "net" after deduction of National Insurance contributions borne by the employee, a transfer** should be made by debiting Wages and crediting the National Insurance Account. For example if the Trial Balance shows—

	£
Wages paid	1,725
National Insurance . . .	305

(the amount deducted from the employees being £175) a transfer will be made accordingly: debit wages £175; credit National Insurance, £175, the revised figures being—

	£
Wages	1,900
National Insurance . . .	130

(5) **Sales.** This account will normally be made up of goods sold, less returns. The question of dealing with returns in the Trading Account is analogous to that relating to purchases. Where goods are out on consignment or sale or return, it is important to ascertain what part is really sold. That part sold and not paid for must be shown as DEBTORS (and not included in stock), that part unsold must be shown as STOCK at cost price, or market price **if lower,** and not as Debtors. Where a business sells goods on condition that the invoice shall be dated "forward," this is usually equivalent to giving the buyer extra credit, but so far as final accounts are concerned the transaction must be treated as a sale, hence passed through as sales and included in Debtors (but not included as Stock). Where the account includes realization of assets a transfer from Sales to the credit of the Asset Account will be required. It should be further observed in connection with the sale of an asset that a resultant transfer will be almost inevitable, i.e. writing off any profit or loss on sale of the asset, as well as depreciation to date of sale.

Illustration. Sales as shown in the Trial Balance are £3,000, which includes the sale of a car (effected half-way through the yearly accounting period) realizing £120. The book value of the car at the commencement of the period was £210, and in the past 20 per cent depreciation has been written off yearly.

The entries will be: debit Sales £120, credit Car Account £120; but as the car stands in the books at £210, there is still a debit of £90 therein to be disposed of, as follows: £21 (i.e. at 20 per cent per annum on £210 for half-year) and £69 for depreciation and loss on sale respectively.

The Car Account will be thus—

Dr. CAR *Cr.*

	To Balance . . .	b/d	£ 210		By Transfer from Sales „ Depreciation . „ Profit and Loss Account: Loss on Sale . . .	£ 120 21 69
			£210			£210

The inclusion of the proceeds of the car in Sales Account, moreover, may convey the hint that the purchase of a new car (if any) has been included incorrectly in Purchases Account; thus involving a transfer from Purchases Account to debit of new Car Account. It may be mentioned further that in the purchase of a new car the vendor often makes an allowance for the old car, and pays the licence for the new car, charging the latter to the purchaser. Such a transaction may involve several adjustments. An illustration is given on pages 117-8.

Where goods are purchased and resold without profit (e.g. where a tobacconist sells to another at cost, in order to obtain the benefit of the bonus given by the Tobacco Co.) the amount of such sale should be transferred to the credit of Purchases Account. Similarly, goods sent out on consignment or to branches should be credited to a separate account and not treated as sales. (These matters will be fully dealt with in the chapters on Consignment and Branch Accounts respectively.)

Where the balances have been extracted and it is discovered that a batch of sales has not been entered, it is usual to remedy the omission by ascertaining the total of such sales and passing an entry through on lines similar to prepayment items (i.e. credit above the line; debit below the line). The former will augment the Sales Account and the latter will represent and be shown as Debtors in the Balance Sheet. The detailed sales figures will be passed through the books on the first day of the new period.

Returns inward will be dealt with conversely.

Illustration. The following items appear (*inter alia*) in the Trial Balance on 31st December, 19..—

	£	£
Debtors	3,500	
Sales		15,200

After ruling off the Day Books and extracting the Trial Balance it is discovered that invoices to customers amounting to £729 have been omitted.

The adjustment will be as follows—

Dr. SALES **Cr.**

19.. Dec. 31	To Trading Account .		£ 15,929	19.. Dec. 31	By Sundries (per Trial Balance) . .		£ 15,200
					„ Sales omitted from Sales Day Book .	c/d	729
			£15,929				£15,929
19.. Jan. 1	To Balance: Sales omitted .	b/d	729				

The Balance Sheet will show Debtors—

	£	£
Per Ledger	3,500	
Sales Account . . .	729	
		4,229

Various terms are commonly used in relation to Sales. These are—

(1) **Cost of Sales.** This term is employed frequently both in ordinary and cost accounting. It is simply the cost price of the goods sold, or the price at which goods would be sold to recover exactly their cost, that is, without either profit or loss. Hence, assuming that in arriving at gross profit no unusual items are included, the cost of sales equals the amount of sales (less returns) less gross profit.

Illustration. Goods are sold for £2,000 (no returns inwards): opening stock is £500. Purchases are £1,200 and closing stock is £300. Find the cost of sales.

	£
Gross Profit is £2,000 plus £300	2,300
Less £500 plus £1,200	1,700
Gross Profit	£600
Cost of Sales is Opening Stock	500
Add Purchases	1,200
	1,700
Less Closing Stock	300
Cost of Sales	£1,400

This gives the same result as—

	£
Sales	2,000
Less Gross Profit	600
Cost of Sales	£1,400

(2) **Turnover.** In addition to its simple meaning of Sales, this term is frequently used to mean the number of times the Stock is "turned over"; in other words the speed of the "turn-over" of the average stock.

The usual criterion is the money equivalent of the yearly sales as compared with that of the average stock, the former being divided by the latter. It is important to have the average stock converted into selling price for this purpose.

There are also two other modes of arriving at the speed of the turnover—

(1) The cost of sales divided by the cost of the average stock.

(2) The quantity (as distinct from the money equivalent) of the goods sold divided by the quantity normally in hand.

When a wide range of goods is carried, it is usually necessary to calculate the turnover figure for each class of goods since the rate will vary considerably for each class. The turnover rate of, say, Motor Lorries or Grand Pianos will be much less, for instance, than that of Groceries, Tobacco, and Meat. The average stock on hand, too, may be greatly affected by bulk purchases made with a view to reducing the buying price.

How the various adjustments dealt with so far in this chapter affect the Final Accounts can be seen from the following illustration.

Illustration.

J. WALTERS

TRIAL BALANCE AS AT 31ST DECEMBER, 19 .

	Dr.	Cr.
	£	£
J. Walters: Capital		4,250
J. Walters: Drawings	710	
Plant and Machinery	950	
Stock, 1st January, 19	1,460	
Purchases	10,362	
Purchases Returns		291
Sales		11,906
Sales Returns	210	
General Expenses	440	
Rent	120	
Rates	200	
Apprenticeship Premiums		80
Bank Overdraft		240
Bad Debts	172	
Sundry Debtors	3,200	
Sundry Creditors		1,000
Cash in Hand	48	
Bad Debts Provision		105
	£17,872	£17,872

You are required to prepare Trading and Profit and Loss Account, for the year ended 31st December, 19.., and Balance Sheet as at that date, showing the adjustments and closing entries in Journal form, having regard to the following—

(1) Write off depreciation on Plant and Machinery at 10 per cent per annum.

(2) The Bad Debts Provision is to be increased to 5 per cent on Sundry Debtors. A discount provision of $2\frac{1}{2}$ per cent on Sundry Debtors is to be created.

(3) Walters has drawn out Goods for his own consumption amounting to £40, of which there is no record in the books.

(4) £100 Plant and Machinery purchased on 31st December, 19.., has been inadvertently included in Purchases.

(5) Rent Accrued is £40.

(6) Rates of £80 are paid in advance.

(7) Stock-in-hand at 31st December, 19.. is valued at £1,730 including stock of stationery £20.

(8) £100 Apprenticeship Premium was received on 1st January in the previous year in respect of a five years' period, and £20 was written off. The same amount is to be written off this year.

(9) General Expenses include—

(*a*) Purchases of stationery £50.

(*b*) Carriage inwards £80, including £20 on the Plant and Machinery purchased on 31st December, 19...

(*c*) Wages £180, including £30 for installation of the new Plant and Machinery. There are £10 wages accruing on 31st December, 19...

(10) Sales include £100 resale without profit. It is discovered that sales to the value of £200 have not been entered in the books at 31st December, 19...

J. WALTERS

Journal

			£	£
19.. Dec. 31	Depreciation . . . . *Dr.* To Plant and Machinery . . Being 10% per annum written off.		95	95
	J. Walters, Drawings . . *Dr.* To Purchases . . . . . Being Goods drawn out of the business for private consumption.		40	40

JOURNAL—(*contd.*)

			£	£
19.. Dec. 31	Plant and Machinery . . *Dr.*		150	
	To Sundries:			
	Purchases			100
	General Expenses (Carriage) .			20
	General Expenses (Wages) .			30
	Being transfers from Purchases and General Expenses of items included therein in error.			
	Rent . . . . . *Dr.*		40	
	To Rent Accrued . . .			40
	Being Balance carried forward.			
	Rates Prepaid . . . *Dr.*		80	
	To Rates			80
	Being Balance carried forward.			
	Sundries . . . . *Dr.*			
	To General Expenses . .			260
	Stationery		50	
	Carriage Inwards		60	
	Wages		150	
	Being allocation of General Expenses to correct accounts.			
	Wages . . . . . *Dr.*		10	
	To Wages Accruing . . .			10
	Being balance carried forward in respect of wages accruing.			
	Sales . . . . . *Dr.*		100	
	To Purchases			100
	Being transfer in respect of goods resold without profit.			
	Sundry Debtors' Total Account (or Sales Account "below the line") *Dr.*		200	
	To Sales			200
	Being sales omitted from Sales Day Book.			

JOURNAL (CLOSING ENTRIES)

			£	£
19.. Dec. 31	Trading Account . . . *Dr.*		11,351	
	To Sundries:			
	Stock			1,460
	Purchases[1] . .	£10,122		
	Less Returns[2] . .	291		
				9,831
	Carriage Inwards . . .			60
	Being Balances transferred.			

[1] Purchases per Trial Balance £10,362, less transfers £240 (see the second, third, and eighth previous Journal entries).

[2] Alternatively, the Returns may be transferred by means of separate Journal entries.

JOURNAL (CLOSING ENTRIES)—(*contd.*)

		£	£
19.. Dec. 31	Sundries . . . . . *Dr.*		
	To Trading Account . .		13,506
	Sales[1] £12,006		
	Less Returns[2] . . . 210	11,796	
	Stock	1,710	
	Being Balances transferred.		
	Trading Account . . . . *Dr.*	2,155	
	To Profit and Loss Account .		2,155
	Being Gross Profit transferred.		
	Apprenticeship Premiums . *Dr.*	20	
	To Profit and Loss Account .		20
	Being yearly sum written off.		
	Profit and Loss Account . *Dr.*	1,013	
	To Sundries:		
	Wages [£150 plus accrual £10]		160
	Rent [£120 plus accrual £40] .		160
	Rates [£200 less prepaid £80] .		120
	Stationery [£50 less Stock £20]		30
	General Expenses[3] . .		130
	Bad Debts		172
	Bad Debts Provision[4] . .		65
	Discounts Provision[5] . .		81
	Depreciation. . . .		95
	Being Balances transferred.		
	Profit and Loss Account. . *Dr.*	1,162	
	To J. Walters, Capital . .		1,162
	Being Net Profit transferred.		
	J. Walters, Capital[6] . . . *Dr.*	750	
	To J. Walters, Drawings . .		750
	Being Balance transferred.		

[1] Sales per Trial Balance £11,906, plus net transfer £100 (see the eighth and ninth Journal entries, page 97).

[2] Alternatively, the Returns may be transferred by means of separate Journal entries.

[3] General Expenses per Trial Balance £440, less transfers £310 (see the third and sixth Journal entries, page 97).

[4] Sundry Debtors per Trial Balance £3,200, plus transfer £200 (see the ninth Journal entry, page 97)—£3,400; 5 per cent of £3,400 is £170, less provision per Trial Balance £105, which leaves £65.

[5] Sundry Debtors £3,400
Less Bad Debts Provision 170

£3,230

2½ per cent of £3,230 is £81 (to the nearest £).

[6] Drawings per Trial Balance £710, plus transfer £40 (see the second Journal entry, page 96).

J WALTERS

TRADING AND PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 19

Dr	£	£	Cr.	£	£
To Stock 1st Jan, 19		1,460	By Sales	12,006	
" Purchases	10 122		*Less* Returns	210	
Less Returns	291				11,796
		9,831	" Stock 31st Dec, 19		1,710
" Carriage Inwards		60			
" Gross Profit c/d		2,155			
		£13 506			£13,506
To Wages		160	By Gross Profit b/d		2,155
" Rent		160	" Apprenticeship Premium		20
" Rates		120			
" Stationery		30			
" General Expenses		130			
" Bad Debts— Written off	172				
Provision	65				
		237			
" Discounts Provision		81			
" Depreciation of Plant		95			
" Net Profit transferred to Capital Account		1,162			
		£2 175			£2,175

J WALTERS

BALANCE SHEET AS AT 31ST DECEMBER, 19

	£	£		£	£
Capital—			Plant and Machinery—		
Balance at 1st Jan 19	4 250		Balance at 1st Jan 19	950	
Less Drawings	750		Additions	150	
	3 500			1,100	
Add Net Profit	1 162		*Less* Depreciation	95	
		4 662			1,005
Apprenticeship Premiums	80				
Less written off	20		Stock in hand—		
		60	Goods	1,710	
Sundry Creditors—			Stationery.	20	
Trade	1,000				1,730
Expenses	50		Sundry Debtors	3,400	
		1,050	*Less* Bad Debts Provision	170	
Bank Overdraft		240			
				3,230	
			Less Discounts Provision	81	
					3,149
			Rates prepaid		80
			Cash in hand		48
		£6 012			£6,012

EXAMINATION PROCEDURE

As the types of questions on this subject-matter are illimitable, it is essential that students should make it a habit in the ***early stages of their preparation*** of working, under time conditions, exercises involving the compilation of final accounts.

It is neither practicable nor desirable to lay down dogmatically any precise method of approach to these problems, but the author has found the following methods adequate to meet the general requirements of students—

(1) Take a rough preliminary survey of the question, carefully underlining dates, nature of business, and unusual items.

(2) Obtain agreement of the Trial Balance.

(3) Note against each individual item in the Trial Balance any adjustment required.

(4) Proceed to build up in skeleton in the Trading and Profit and Loss Account and Balance Sheet ONLY those items that are "straightforward," that is, those items that require no adjustments, ticking each item in the Trial Balance as it is disposed of.

(5) Next deal with remaining items (i.e. those requiring adjustment), making sure that the double-entry has been completed; the Trial Balance item should be ticked up to the adjustment note.

(6) Insert closing stock first in the Trading Account and then in the assets side of the Balance Sheet, ticking up the adjustment note.

(7) Avoid, if possible, a "piecemeal" treatment of adjustments and stock; that is to say, deal at one and the same time completely with the adjustments, and if several items are involved, open rough working accounts to avoid confusion.

(8) Until the problem is complete it is advisable to insert totals in pencil.

(9) In case of ambiguity in the question, think out the most reasonable and common sense view and proceed accordingly; state your assumptions, supporting them with reasons, and other possible assumptions.

(10) Ascertain whether any self-evident adjustments are required in accordance with the facts given in the problem, e.g. where the Trial Balance shows a loan outstanding and there is a debit charge for loan interest for a period only. If, for instance, the accounts are for a year and the debit for loan interest is for the half-year, an adjustment is clearly required (provided that the loan did not arise halfway through the year) to increase the loan interest debit to a full year's charge, with a corresponding liability for the half-year's interest unpaid.[1]

In examination work it is usually unprofitable to spend much time attempting to discover the out-of-balance where such exists.

The following points are illustrative of common failings in this type of problem—

(1) Failure to complete the double-entry of the adjustments, e.g. insertion of closing stock in the Trading Account, but its omission in the Balance Sheet; the increase of an expense in the Profit and Loss Account and omitting to show the accrual as a *liability* in the Balance Sheet.

[1] The same principle applies where Loan Interest is shown "net," i.e. after deduction of Income Tax (see Chapter XXI).

(2) **Incorrect or incomplete treatment of Bad and Doubtful Debts** and similar provisions; the most frequent error being the ADDITION of the Bad and Doubtful Debts Provision to the Debtors instead of DEDUCTION in the Balance Sheet.

(3) Failure to carry out "inset" items.

(4) Failure to provide for interest on loans and depreciation where the facts in the question clearly indicate the necessity for so doing.

(5) Failure to "clear" all the Trial Balance figures or the careless insertion of amounts on the incorrect side of the Profit and Loss Account and Balance Sheet.

(6) Failure to close off by a transfer to Capital Account of the balance of the Profit and Loss Account.

(7) Careless lack of observation of important details, e.g. the period of the accounts, nature of the business, distinction between capital and revenue and the like.

As the examination bodies frequently require the preparation of Final Accounts from a schedule of balances, illustrations are provided in the succeeding pages of the working of the final accounts both from the orthodox Trial Balance and from a schedule of the balances.

(1) **From the Complete Trial Balance.** It should be noted that rough workings—this is imperative where the adjustments are complicated—should be submitted, as the examiner's purpose is to test knowledge of PRINCIPLES; and further, he is not oblivious to the fact that the examinee is working under what may be considered as very unfavourable conditions.

Illustration. The Trial Balance of A on 31st December, 19.., follows—

	Dr	*Cr.*
	£	£
Debtors	2,000	
Creditors		**1,400**
Drawings	**420**	
Capital		**2,500**
Stock, 1st Jan., 19..	**1,200**	
Purchases	6,200	
Sales		7,302
Sales Returns	**60**	
Wages	**900**	
General Expenses	350	
Bank		**290**
Fixtures and Equipment	400	
Bad Debts	172	
Bad Debts Provision		210
	£11,702	£11,702

(i) Closing Stock, £1,470.

(ii) Stock destroyed covered by Insurance (not yet paid), £150.

(iii) Provide 20% on Debtors for Bad Debts.

(iv) Included in Sales is £50, being Sale of Fixtures, book value, £80; Depreciation thereon, to date of sale, £5.

(v) Expenses accruing, £25.

(vi) Included in Purchases is a new Typewriter, £13, bought on 31st December of the current year.

(vii) Write 10% Depreciation off Fixtures.

The items in heavy type are straightforward and do not require adjustment.

The skeleton will first be prepared by the insertion of the items complete in themselves and not influenced by the required adjustments. This will appear as follows—

Trading and Profit and Loss Account for the Year Ended 31st December, 19..

Dr. *Cr.*

19..		£	£	19..		£	£
Jan. 1	To Stock		1,200	Dec. 31	By Sales		
Dec. 31	,, Purchases				*Less* Returns	60	
	,, Wages		900		,, Stock Destroyed		
					,, Stock on hand		
	,, General Expenses						
	,, Bad Debts						
	,, Depreciation: Fixtures						
	,, Loss on Sale of Fixtures						

Balance Sheet as at 31st December, 19..

Capital—	£		Fixed Assets—	£	
Balance 1st Jan., 19..	2,500		Fixtures and Equipment:		
Less Drawings	420		Balance 1st Jan., 19..		
		2,(	*Less* Sale		
			,, Loss on Sale		
			,, Depreciation		
Current Liabilities—			*Add* Purchases		
Creditors	1,400				
Bank Overdraft	290		Current Assets—		
Expenses accruing			Stock		
			Debtors		
			Less Bad Debts Provision		
			Insurance Co.		

At this stage all the items that can be completely disposed of have been inserted in the appropriate place in the Trading and Profit and Loss Account or Balance Sheet, and in an exercise will have been duly ticked up.

In addition, it will be observed that other expenses and adjustment items, not in the Trial Balance itself but required by the question, have been inserted WITHOUT figures, thus facilitating the double-entry of the adjustments by avoiding the necessity of having to perform the "writing" part at the time of insertion of the relevant figures.

It is now necessary to deal with each adjustment.

(i) *Closing Stock.* This will be inserted in the Trading Account on the credit side and immediately after this entry in the Balance Sheet on the assets side.

(ii) *Stock Destroyed.* The Trading Account should be credited with the amount as if it actually existed, and the Profit and Loss Account debited as a separate item if not covered by insurance, or in the probable event of its being so covered, the amount will go to the debit of the Insurance Company. The adjusting entries will therefore be—

Debit Profit and Loss Account Credit Trading Account	If not insured.
Debit Insurance Company Credit Trading Account	If fully insured.

In the event of the loss being partly covered, the proportion

insured against will be debited to the Insurance Company and the uninsured portion passed to the debit of Profit and Loss Account, the total of the two being credited to Trading Account.

It is quite conceivable that the insurance claim may have been passed through the books as a sale and the Insurance Company debited; in these circumstances a transfer should be made by debiting Sales and crediting Trading Account as a separate entry for such amount, the Insurance Company's account having already been debited.

The transfer required where there is no insurance of the goods, or if partly insured, then to the extent of the loss not covered, will not reflect itself in the Balance Sheet at all, and actually will not amend the NET profit, but will INCREASE the GROSS profit and INCREASE the debit side of the Profit and Loss Account.

(iii) *Bad Debts Provision.* The following rough working account will be prepared, and although such working account would be attached to the written answer to the problem there is no necessity to embellish it so long as it is made perfectly clear to the examiner what accounting process or processes it contains. Thus—

Bad Debts A/c	£	£	Bad Debts Provision	£		£
T.B. . . .	172		New Provision (in B.S.)	400	T.B. .	210
B.D.P. . . .	190				B.D. A/c.	190
	—	362 *Dr.* P & L.				

Hence £362 will be debited to the Profit and Loss Account and the new Provision of £400 shown as a deduction from Debtors. Both of the above will completely dispose of the Bad Debts Account, and the Bad Debts Provision appearing in the Trial Balance. This is made clear by a comparison of the Trial Balance and the Final Accounts figures, i.e.—

> **Trial Balance:** *Dr.* £172 and *Cr.* £210; difference *Dr.* £38.
> **Final Accounts:** *Dr.* £362 and *Cr.* £400; difference *Dr.* £38.

(iv) *Expenses accruing* £25. This will merely increase the Expenses in the Profit and Loss Account and be shown in the Balance Sheet as a liability.

The next adjustment is of a composite nature because the adjustments called for are interwoven with more than one account, so that the appropriate accounts may be referred to by letter or some other special designation.

Adjustment for sales, fixtures, depreciation, etc., are referred to as "A" in the final accounts on page 105.

Rough working accounts will be prepared—

Sales				Purchases			
	£		£		£		£
FIXTURES .	50	T.B. . .	7,302	T.B. . .	6,200	FIXTURES, etc.	13
Trading . .	7,252					Trading . .	6,187

Fixtures and Equipment				Depreciation			
	£		£		£		£
T.B. . .	400	SALES . .	50	FIXTURES .	5		
		DEPN. . .	5	FIXTURES .	[1]32	P. & L. . .	37
		P. & L. . .	25				
PURCHASES .	13	DEPN. . .	32				
		Balance .	301				

The transfers between the accounts themselves have been inserted in BLOCK letters for clearness.

After these adjustments have been effected, the balance of the Trading and Profit and Loss Account will be transferred to Capital Account or (as it is unnecessary formally to open the latter account), added to or subtracted from the Capital Account in the Balance Sheet, according to whether the result disclosed is a profit or loss.

The Final Accounts will then be as shown on page 105.

Illustration. The Trial Balance of A at 31st December, 19.., is—

Trial Balance	*Dr.*	*Cr.*
	£	£
Capital		22,000
Drawings	10,000	
Sundry Creditors		10,401
Loan on Mortgage		9,500
Interest on Loan	300	
Goodwill	5,000	
Cash in Hand	50	
Sundry Debtors	20,100	
Bad Debts Provision		710
Stock, 1st January, 19..	4,839	
Plant and Machinery	8,000	
Bank	2,555	
Land and Buildings	12,000	
Bad Debts	525	
Purchases	51,458	
Purchases Returns		1,346
Sales		116,246
Sales Returns	7,821	
Carriage Outwards	2,004	
Wages	15,485	
Salaries	6,097	
Carriage Inwards	929	
Rents and Rates	2,000	
Gas, Water, and Electricity	720	
Insurance	171	
Advertising	3,264	
Discounts Received		1,100
Discounts Allowed	560	
Investments, at Cost	5,000	
General Expenses	3,489	
Bills Payable		2,614
Bills Receivable	1,800	
Dividends Received		250
	£164,167	£164,167

[1] On £400 − 80 = £320 at 10% per annum.

Trading and Profit and Loss Account for the Year Ended 31st December, 19..

19..			£	£	19..			£	£
Jan. 1	To Stock			1,200	Dec. 31	By Sales		7,252	
Dec. 31	" Purchases (see A)			6,187		*Less* Returns (see A)		60	
	" Wages			900					7,192
	" Gross Profit	c/d		525		" Stock Lost (see ii)			150
						" Stock in Hand (see i)			1,470
				£8,812					£8,812
Dec. 31	To General Expenses (see iv)			375	Dec. 31	By Gross Profit	b/d		525
	" Bad Debts (see iii)			362		" Net Loss transferred to Capital Account			274
	" Depreciation: Fixtures & Equipment (see A)			37					
	" Loss on Sale of Fixtures (see A)			25					
				£799					£799

Balance Sheet as at 31st December, 19..

	£	£			£	£
Capital—			Fixed Assets—			
Balance 1st January, 19..	2,500		Fixtures & Equipment:			
Less Drawings	420		Balance 1st January, 19..		400	
	2,080		*Less* Sale	£ 50		
Less Net Loss per Trading and Profit and Loss Account	274		Loss on Sale	25		
		1,806	Depreciation	37	112	
Current Liabilities—					288	
Creditors	1,400		*Add* Purchases (see A)		13	
Bank Overdraft	290					301
Expenses accruing (see iv)	25	1,715	Current Assets—			
			Stock (see i)		1,470	
			Debtors	£ 2,000		
			Less Bad Debts Provision (see iii)	400	1,600	
			Insurance Company (see ii)		150	3,220
		£3,521				£3,521

Notes. (1) If the Stock had been insured for, say, £100 only, £50 would be debited to Profit and Loss Account and £100 to the Insurance Company.

(2) As the question is not clear as to whether the loss on Stock had already been adjusted prior to the Trial Balance, a footnote should be made to the student's answer.

You are required to prepare Trading and Profit and Loss Account for the year to 31st December, 19.., and Balance Sheet as at that date, after making provision for the following—

(1) Depreciation—Plant and Machinery, 10 per cent per annum; Land and Buildings, 5 per cent per annum.

(2) End Stock on hand—31st December, 19.., £5,100.

(3) The Investments at 31st December, 19.., are worth £5,500 at market values.

(4) £200 is outstanding in respect of Rent and Rates.

(5) Insurances are prepaid, £50.

(6) The Bad Debts Provision is to be maintained at 5 per cent of Sundry Debtors.

(7) Loan Interest at 6 per cent per annum is to be charged for full year having regard to the fact that £500 was repaid on 30th June, 19...

(8) The Manager is to get a commission of 1/10th on the net trading profits after charging his commission.

(9) Transfer £2,250 to Reserve.

(10) 3/4ths of the Rent and Rates are to be charged against trading.

(11) 17/24ths of Gas, Water, and Electricity are to be charged against trading.

TRADING AND PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 19 .

Dr.		£	£			£	Cr. £
To Stock, 1/1/19..			4,839	By Sales		116,246	
,, Purchases		51,458		*Less* Returns		7,821	
Less Returns		1,346					108,425
			50,112	,, Stock, 31/12/19..			5,100
,, Carriage Inwards			929				
,, Wages			15,485				
,, Rent and Rates			1,650				
,, Gas, Water and Electricity			510				
,, Gross Profit	c/d		40,000				
			£113,525				£113,525
To Rent and Rates			550	By Gross Profit	b/d		40,000
,, Gas, Water and Electricity			210	,, Discounts Received			1,100
,, Insurance			121	,, Dividends ,,			250
,, Carriage Outwards			2,004				
,, Salaries			6,097				
,, Advertising			3,264				
,, Discounts Allowed			560				
,, Bad Debts			820				
,, Loan Interest			585				
,, General Expenses			3,489				
,, Depreciation— Plant and Machinery		800					
Land and Buildings		600					
			1,400				
,, Manager's Commission			2,000				
,, Net profit transferred to Profit and Loss Appropriation Account	c/d		20,250				
			£41,350				£41,350

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT **Cr.**

		£			£
To Transfer to Reserve . . .		2,250	By Net Profit for Year . .	b/d	20,250
,, Net Profit transferred to Capital Account . . .		18,000			
	£	20,250		£	20,250

BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£	£		£	£
Capital 1st Jan., 19.. . . .	22,000		Fixed Assets—		
Less Drawings . . .	10,000		Goodwill		5,000
	12,000		Land and Buildings . .	12,000	
,, *Add* Net Profit per Profit and Loss Appropriation Account	18,000		*Less* Depreciation . .	600	11,400
		30,000	Plant and Machinery . .	8,000	
Reserve		2,250	*Less* Depreciation . .	800	7,200
Loan on Mortgage . . .		9,500	Investments at Cost (market value £5,500) . . .		5,000
Current Liabilities—					28,600
Sundry Creditors:			Current Assets—		
Trade	10,401		Stock.	5,100	
Rent and Rates . . .	200		Sundry Debtors . £20,100		
Manager's Commission .	2,000		*Less* Bad Debts Prov. 1,005	19,095	
Mortgage Interest due. .	285		Expenses prepaid (Insurance)	50	
Bills Payable	2,614	15,500	Bills Receivable	1,800	
			Cash in hand	50	
			Cash at Bank	2,555	28,650
	£	57,250		£	57,250

Notes. (1) The Loan Interest has been computed as follows—

	£	
6% per annum on £10,000 for 6 months .	300	(already paid)
6% per annum on £9,500 for 6 months .	285	(outstanding)
	£585	

(2) Computation of Manager's Commission equals 1/11th of the profit of the business *before* the Profit and Loss Account has been credited with dividends and debited with the commission, viz.—

	£
Net profit	20,250
Add Commission	2,000
	22,250
Less Dividends (non-trading receipts) .	250
	£22,000

One-eleventh thereof = £2,000

Subject to agreement, depreciation should, for the purpose of calculating commission, be computed on the straight line method.

The commission is based, in the absence of an agreement otherwise (as in this problem) on the profits *before* charging commission.

(2) Where the Items are Shown in Single Columnar Form. No difference in principle arises in these circumstances as compared with the presentment of a complete Trial Balance. The additional work involved is the separation of items, so as to form, prior to the preparation of the Final Accounts, the Trial Balance. The time entailed in rewriting is usually considerable and cannot easily be spared in examinations, so that a "short cut" method should be employed.

The method usually adopted is to add the whole list (after ascertaining that the list or schedule comprises only Ledger Balances) and either extract the credits by the side of the schedule or on a separate sheet, and the total schedule less the credits extracted should equal the latter figure. There is no reason why credits instead of debits should be extracted, but from the point of view of expediency it is almost invariably better to extract credits inasmuch as they are comparatively few in number.

Many of the advanced problems require adjustments of errors or omissions before the list of balances is complete; that is, not infrequently the list of balances does not contain the whole story. In subsequent chapters will be found illustrations of this type.

When the Trial Balance is obtained the problem will be worked out on the usual lines.

Illustration. The following is the Schedule of balances on 31st December, 19.., of X—

Ledger items	Balances	Debits	Credits
	£	£	£
Purchases	1,200	1,200	
Debtors	1,700	1,700	
Bank Overdraft	50		50
Loan	180		180
Fixtures	200	200	
Capital	1,500		1,500
Drawings	300	300	
Expenses	420	420	
Bad Debts Provision	90		90
Creditors	280		280
Sales	1,900		1,900
Sales Returns	50	50	
Stock	130	130	
	£8,000	£4,000	£4,000

The items are also shown in Trial Balance form for reference.

The procedure in a question of this nature will be—

	£	£
(1) Total of balances		8,000
(2) Credit items	50	
	180	
	1,500	
	90	
	280	
	1,900	
Deduct (2) from (1)		4,000
∴ Total Debit items		£4,000

Where items (e.g. Bank, Loans, Discounts) are ambiguous, the question will generally give some indication or hint as to the correct side of the particular item. For instance, Bank Interest (Dr.) would suggest a bank overdraft.

Illustration. The following are the balances which appeared in the books of X, who is an Hotel Proprietor, at 31st December, 19..—

	£
Apartments and Attendance	28,000
Meals	16,000
Provisions	7,750
Stocks	510
Cash in Bank	5,000
Capital	110,000
Debtors	400
Creditors	4,800
Provision for Depreciation of Buildings . .	12,000
Buildings	105,000
Furniture and Equipment	30,000
Bank Interest	565
General Expenses	13,705
Wages	3,000
Income Tax	240
Drawings	760

Prepare Final Accounts after making adjustments as follows—

(1) Increase Provision for Depreciation of Buildings to £15,000.

(2) A sum of £400 representing accommodation £120, and meals £280 to be charged to X.

(3) A sum of £800 representing accommodation £280 and meals £520 to be charged up in respect of Staff.

The "Trial Balance" is—

	£
(1) Total of *all* the items . . .	332,730
(2) Total of Credit items . . .	166,365
∴ Total Debit items . =	£166,365

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 19..

Dr.		£		*Cr.*	£
To Provisions		7,750	By Apartments, etc.		23,400
,, Wages		3,800	,, Meals		16,800
,, General Expenses		13,705	,, Bank Interest		565
,, Depreciation of Buildings		3,000			
,, Net Profit transferred to Capital Account		12,510			
		£40,765			£40,765

BALANCE SHEET AS AT 31ST DECEMBER, 19

	£	£		£	£
Capital—			Fixed Assets—		
Balance at 1st Jan., 19.	110,000		Buildings	105,000	
Less Drawings	1,400		*Less* Depreciation	15,000	
					90,000
	108,600				
			Furniture and Equipm't		30,000
Add Net Profit per Profit and Loss Account	12,510		Current Assets—		
			Stocks	510	
		121,110	Debtors	400	
Current Liabilities—			Cash at Bank	5,000	
Creditors		4,800			5,910
		£125,910			£125,910

Notes The General Expenses (which should include the complete upkeep and renewals of furniture, crockery, linen, etc.) would be in more detail in an examination question

The adjustments will be effected thus—

	£	Apartments	£	Meals	£
Debit Drawings	400	Credit	120	Credit	280[1]
Debit Wages	800	Credit	280	Credit	520
	£1,200	Increase of	£400	Increase of	£800

Income Tax, £240, will also be transferred to Drawings, hence total Drawings are £1,400, i.e. £760 + £240 + £400

Stocks are Closing Stocks (the credits already having been made to the appropriate Nominal Accounts)

Illustration. From the following balances prepare Final Accounts in respect of the year ended 31st December, 19..—

	£		£
Loan	500	Creditors	8,740
Sundry Expenses	398	Income Tax	203
Stock (1st January, 19)	5,470	Investments	2,000
Purchases	31,400	Fixtures and Fittings	600
Wages	2,000	Motor Vans	500
Discounts Allowed	126	Investment Provision	500
Rent and Rates	170	Bad Debts written off	20
Sales	37,000	Bad Debts Provision	820
Carriage Inwards	224	Bank Interest	15
Bank	3,247	Capital	9,150
Sundry Debtors	1,900	Dividends on Investments	107
Buildings	2,674	Drawings	400

[1] Alternatively, the amounts representing meals may be credited to Provisions Account instead of being credited to Meals Account

(1) Stock in hand at 31st December, 19.., £3,517 (including Stationery Stock £17).
(2) Sundry Expenses include stationery purchased, £37.
(3) The Loan was made on 1st March of the current year; interest at the rate of 6% per annum no provision for which has yet been made.
(4) Investments valued at £1,420; adjust Investment Provision accordingly.
(5) Provide 5% on Debtors for Discounts and 20% for Bad Debts.
(6) Write off 5% for Depreciation on Buildings.
(7) Included in Sundry Expenses is £26 for Legal Charges in connection with the acquisition of certain buildings (included in the item of £2,674).
(8) Dividends accruing, £27; Rates paid in advance £20 and Rent owing £30.
(9) The opening stock included Stationery Stock £20.

Trading and Profit and Loss Account for the Year Ended 31st December, 19..

Dr. | *Cr.*

19..			£	19..			£
Jan. 1	To Stock		5,450	Dec. 31	By Sales		37,000
Dec. 31	,, Purchases		31,400		,, Stock		3,500
	,, Carriage Inwards		224				
	,, Wages		2,000				
	,, Gross Profit	c/d	1,426				
		£	40,500			£	40,500
Dec. 31	To Rent and Rates		180	Dec. 31	By Gross Profit	b/d	1,426
	,, Sundry Expenses		335		,, Bank Interest		15
	,, Stationery		40		,, Dividends		134
	,, Loan Interest		25				
	,, Bad Debts		80				
	,, Discounts (net)		202				
	,, Depreciation—						
	Buildings	£135					
	Investments	80					
			215				
	,, Net Profit transferred to Capital Account		498				
			£1,575				£1,575

Balance Sheet as at 31st December, 19.

	£	£		£	£
Capital—			Fixed Assets—		
Balance 1st Jan., 19..	9,150		Buildings:		
Less Drawings	603		Balance 1st Jan., 19	?	
	8,547		Additions	?	
Add Net Profit per Trading and Profit and Loss A/c	498			2,674	
		9,045	*Add* Legal Charges on Purchase	26	
Loan		500		2,700	
Current Liabilities—			*Less* Depreciation at 5%	135	
Creditors	3,740				2,565
Rent owing	30		Fixtures and Fittings		600
Loan Interest	25	3,795	Motor Vans		500
			Investments	2,000	
			Less Provision	580	1,420
					5,085
			Current Assets—		
			Stock: Goods	3,500	
			Stationery	17	
			Sundry Debtors £1,900		
			Less Bad Debts Prov. 380		
			1,520		
			Less Discount Prov. 76		
			1,444		
			Add Rates paid in Advance 20		
			Add Dividends accruing 27		
				1,491	
			Cash at Bank	3,247	
					8,255
		£13,340			£13,340

In absence of date of purchase of new buildings, depreciation taken at 5% on the balance at 31st December, 19..

MISCELLANEOUS ADJUSTMENTS

Having grasped the principles relating to the preparation of final accounts with comparatively elementary adjustments, a student will now be the better able to advance a step further. Therefore, examples will now be given illustrating as many types of adjustment as are compatible with the degree of knowledge that, at this stage, the student is reasonably assumed to have attained.

It will be recognized that many adjustments call for a considerable knowledge of advanced accounting and these will be dealt with in Chapters XXII and XXIII.

The almost inexhaustible number of adjustments makes it impossible to illustrate them completely, but the following are typical—

(1) Included in the accounts are Plant and Machinery, £2,000; Investments, £3,200; Loose Tools, £720.

Plant and Machinery are to be written down by 10 per cent; Investments are revalued at £1,950; Loose Tools at £780.

During the year certain investments have been sold for £750, realizing a profit of £170 and passed through Sales Account; sundry loose tools have been purchased for £240 in respect of which carriage of £5 has been expended, the items being charged respectively to Purchases and Carriage.

As no dates are given, the assumption is naturally that the figures given in the first sentence are those in the books at the commencement of the period.

The adjustments are—

		£	£
Re Plant—			
(*a*) Trading and Profit and Loss Account	*Dr.*	200	
To Plant and Machinery .			200
Re Investments—			
(*b*) Sales Account	*Dr*	750	
To Investment Provision .			170[1]
,, Investment Account .			580

	£
The book value of Investments now is £3,200 *less* £580 . .	2,620
And as the revised value is	1,950
A Provision is necessary for . . .	£670[1]

		£	£
Re Loose Tools—			
(*c*) Loose Tools	*Dr.*	245	
To Purchases . . .			240
,, Carriage . . .			5

[1] But assuming no other items appear in the Provision, e g a commencing figure or other profits or losses on realization, the Investment Provision already is in credit for £170, thus requiring a further £500 more to augment it to £670, that is—

		£	£
Profit and Loss Account . . .	*Dr.*	500	
To Investment Provision . .			500

Assuming there had been no sales of Loose Tools or other transactions not disclosed, the amount of Loose Tools will now be—

	£	£
Per Accounts	720	
Add Purchases and Carriage . .	245	
		965
As the revised value of Loose Tools is .		780
The required Depreciation is . .		£185

Entries for Depreciation of Loose Tools—

	£	£
(c) Trading and Profit and Loss Account *Dr.*	185	
To Loose Tools . . .		185

Alternatively, Loose Tools may be treated exactly like Stock, i.e. the commencing figure of £720 would be debited to Trading Account; Purchases and Carriage (£245) transferred separately to Trading Account; and the closing figure £780 introduced into the Final Accounts by the familiar entries—

	£	£
Loose Tools . . . . . *Dr.*	780	
To Trading Account . . .		780

Actually Loose Tools will be unlikely to appear in accounts other than those relating to manufacturing, but the adjustment is introduced here for purposes of illustration.

(2) A acquired a business from C on 1st September, 1952, and included in his expenses was one quarter's rent to 29th September, 1952, to the amount of £60; he makes up his accounts to 31st January, 1953. September quarter rent paid 2nd October, 1952; December quarter 31st January, 1953.

When he acquired the business A would receive credit for the rent accruing up to the date of acquisition, viz. two months from 24th June, 1952, to 1st September, 1952. Actually the computation would be in days and there would almost necessarily be several other items to be allowed or charged as between A and C.

The entries would be as under—

Dr. C *Cr.*

1952 Sept. 1	To Accruing Rent .		£ 40[1]				

[1] This debit will have been settled up either against the cost of acquisition of the business, or against adjustments in favour of C, e.g. prepayments, or in cash.

If, by error, the £40 debit to C and credit to Rent had not been effected at the date of acquisition, it would probably be done at the date when A paid the quarter's Rent to 29th September, 1952; or upon the preparation of the final accounts.

Dr. RENT *Cr.*

			£				£
1952 Oct. 2	To Cash: One Quarter's Rent to 29th Sept., 1952		60	1952 Sept. 1	By C for Rent accruing to 1st Sept., 1952		40
1953 Jan. 31	" Cash: One Quarter's Rent to 25th Dec., 1952		60	1953 Jan 31	" Profit and Loss Account		100[1]
	" One Month's Rent accruing to 31st Jan., 1953	c/d	20				
			£140				£140
				Feb 1	By Balance: One Month's Rent accruing	b/d	20

[1] As the Rent is £20 a month there should be a charge to Profit and Loss Account of £100, made up of five months from 1st September, 1952, to 31st January, 1953, at £20 a month.

(3) The Trial Balance of X shows the account of the Z Building Society as credit £1,225.

It is ascertained that the balance due at the commencement of the year was £1,346.

From the records supplied by the Building Society it is found that the £121 paid (i.e. £1,346 – £1,225) is made up of—

	£
Repayments of Capital	34
Loan Interest	86
Fire Insurance	1
	£121

The required entries are—

		£	£
Fire Insurance	*Dr.*	1	
Loan Interest	*Dr.*	86	
To Z Building Society			87

The Ledger Account of the Z Building Society will be—

Dr. Z BUILDING SOCIETY *Cr.*

		£			£
To Cash		121	By Balance	b/d	1,346
" Balance	c/d	1,312	" Interest (*a*) [1]		86
			" Insurance (*b*) [1]		1
		£1,433			£1,433
			By Balance[2]	b/d	1,312

[1] Alternatively "By Sundries £87."

	£
[2] Beginning Balance	1,346
Less Repayments of Capital	34
Closing Balance	£1,312

(*a*) and (*b*) The postings will be made to the debit of the appropriate account, and the usual adjustment for prepayment (Insurance) and for accruals (Interest) unless (as would be probably the case) the amounts were trivial

(4) A trader with property standing in his books at £12,300, sold a portion of it for £4,200. The latter represents a profit of 20 per cent

on book value. The date of the sale was 30th June, 19.., the accounting period ends on 31st December, and depreciation at 10 per cent has always been written off.

(*a*) If the phrase "profit of 20 per cent on book value" means value left *standing in* the books at 1st January, 19.., the entries, ignoring narrations, are—

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		£	£
Depreciation	*Dr.*	175	
To Property			175
Cash	*Dr.*	4,200	
To Property			4,200
Depreciation	*Dr.*	880	
To Property			880
Property	*Dr.*	875	
To Profit on Sale			875

LEDGER

Dr. PROPERTY *Cr.*

			£				£
19.. Jan. 1	To Balance	b/d	12,300	19.. June 30	By Cash: Sale		4,200
June 30	" Profit and Loss Account: Profit on Sale		875		" Depreciation 5% on £3,500		175
				Dec. 31	" Depreciation 10% on £8,800		880
					" Balance.	c/d	7,920
			£13,175				£13,175
19.. Jan. 1	To Balance (*i*)	b/d	7,920				

	£
(*i*) Book value of remaining Property (£12,300 − £3,500)[1]	8,800
Less 10% Depreciation	880
Balance per Ledger	£7,920

It will be seen that if the sale had realized exactly the depreciated value at 30th June, 19.., it would have been £3,500 less 5 per cent depreciation. Thus—

	£
Book Value	3,500
Less Depreciation	175
	£3,325

As the sale price is £4,200 the profit is £875, as shown below—

	£
Sale Price	4,200
Less Depreciated Value	3,325
= Profit on Sale	£875

[1] The book value of the property sold was five-sixths of sale price, i.e. £3,500, therefore the profit must be—

	£
Sale Price	4,200
Less Book Value	3,500
	700
Plus Depreciation	175
= Profit on Sale	£875

(*b*) If the phrase "profit of 20 per cent on book value" means the value *after* depreciation on the part sold has been dealt with on 30th June, 19.., the entries, ignoring narrations, are—

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		£	s.	d.	£	s.	d.
Depreciation	Dr.	184	4	3			
To Property					184	4	3
Cash	Dr.	4,200	0	0			
To Property					4,200	0	0
Depreciation	Dr.	861	11	7			
To Property					861	11	7
Property	Dr.	700	0	0			
To Profit on Sale					700	0	0

LEDGER

Dr. PROPERTY Cr.

19..			£	s.	d.	19..			£	s.	d.
Jan. 1	To Balance	b/d	12,300	0	0	June 30	By Cash Sale		4,200	0	0
June 30	" Profit and Loss Account: Profit on Sale		700	0	0		" Depreciation 5% on £3,684 4s 3d		184	4	3
						Dec. 31	" Depreciation 10% on £8,615 15s. 9d.		861	11	7
							" Balance	c/d	7,754	4	2
		£	13,000	0	0			£	13,000	0	0
19..											
Jan. 1	To Balance (*i*)	b/d	7,754	4	2						

	£	s.	d.
(*i*) Total Book Value of Property at 1st Jan., 19..	12,300	0	0
Less Book Value of Property Sold	3,684	4	3
	8,615	15	9
Less 10% Depreciation	861	11	7
Balance per Ledger	£7,754	4	2

The January book value of the property sold must be $\frac{100}{95}$ of the written down value; and the latter must be $\frac{5}{6}$ of the sale price of £4,200 (equals £3,500).

Therefore—

	£	s.	d.
Book Value at 1st January, 19.., of the property sold $= \frac{100}{95} \times$ £3,500	3,684	4	3
which, after providing Depreciation at 10% per annum for half-year (i.e. 5%)	184	4	3
Leaves net Book Value at 30th June, 19..	£3,500	0	0

Proof—

	£	s.	d.
Sale Price	4,200	0	0
Book Value at 30th June, 19.., as written down	3,500	0	0
∴ Profit	£700	0	0

This is a profit of 20% of Book Value (as written down), i.e. $\frac{1}{5} \times$ £3500 = £700
do. 16⅔% of sale price i.e. $\frac{1}{6} \times$ £4200 = £700

(5) Included in the Purchases Day Book of a trader, who draws his accounts up to 31st December of each year, is the following item—

		£	s.	d.
19.. May 17	Dud & Co. (Motor)	516	0	0

On examining the invoice you find the following material facts—

		£	s.	d.
19.. April 30	Purchase of New Car	650	0	0
	Accessories	30	0	0
	Licence to 31st December, 19.. . . .	17	5	0
		697	5	0
	Less Old Car	100	0	0
		597	5	0
	Less 10% Trade Discount on £550 . . .	55	0	0
		542	5	0
	Less 5% Cash Discount on £525 . . .	26	5	0
		£516	0	0

Received Cash,
17th May, 19..
(Signed) DUD & Co.

Assuming depreciation at 20 per cent per annum you are required to make the necessary adjustment.

The old car stood in the books at £180.

ADJUSTMENTS STATEMENT

Particulars	Gross			Trade Discount			True Price			Cash Discount			Net		
	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.
Cost of New Car .	650	0	0	65	0	0	585	0	0	29	5	0	555	15	0
Accessories . .	30	0	0				30	0	0	1	10	0	28	10	0
	680	0	0	65	0	0	615	0	0	30	15	0	584	5	0
Deduct Old Car .	100	0	0	10	0	0	90	0	0	4	10	0	85	10	0
	580	0	0	55	0	0	525	0	0	26	5	0	498	15	0
Add Car Licence .	17	5	0										17	5	0
	£597	5	0										£516	0	0

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		£	s.	d.	£	s.	d.
19..							
April 30	New Car . . . . . . *Dr.*	555	15	0			
	Licence . . . . . . *Dr.*	17	5	0			
	Accessories . . . . . *Dr.*	28	10	0			
	To Purchases				516	0	0
	,, Old Car				85	10	0
	Being the necessary adjustments as per statement attached.						
Dec. 31	Depreciation . . . . . *Dr.*	86	2	0			
	To Old Car				12	0	0
	,, New Car				74	2	0
	Being depreciation at 20% on the Old Car for 4 months, and on the New Car for 8 months.						
	Profit and Loss Account . . *Dr.*	82	10	0			
	To Old Car				82	10	0
	Being the loss on the Old Car written off.						

NOTES. (1) The question indicates that the Trade Discount would only be allowed on the motor-cars

(2) The transaction was entered in the Purchases Day Book on the day the receipt was given, namely, 17th May; this, however, is not correct, as the car was actually purchased on 30th April.

(3) The narratives are added for purposes of illustration, but are not necessary when working an exercise on the final accounts.

(4) Actually there would be an allowance to the purchaser in respect of the unexpired licence on the *old* car, which would be offset against that in respect of the new car.

(6) A company draws up its accounts half-yearly to 31st July and 31st January. On 1st October, 1952, it commences to occupy its own factory newly built.

The rating authorities assessed the company at a rateable value (net) of £800. The company on receipt of the assessment in December, 1952, appealed, which appeal at 31st January, 1953, had not been heard.

On 15th December, 1952, the company paid rates on account £220.

The appeal was heard and settled in February, 1953, the assessment being reduced to £600 net. On 10th May, 1953, the Company paid £210 on account of the following Demand Note—

	£
Rates for 1953–54, £600 at 16s.	480
Add balance of Rates 1952–53	80
	560
Less allowance for the over-assessment, £200 at 15s.	75
	£485

On 1st November, 1953, the whole of the balance due, viz. £275, was paid.

Write up the Rates Account of the Company in respect of the three periods ended 31st January, 1954.

Dr. RATES *Cr.*

			£				£
1952 Dec. 15	To Cash on account .		220	1953 Jan. 31	By Rates prepaid . .	c/d	20
					,, Profit and Loss Account (4 months on £800 at 15s. in £) .		200
			£220				£220
1953 Feb. 1	To Balance— Rates prepaid .	b/d	20	July 31	By Rates prepaid (3) .	c/d	45
May 10	,, Cash on account .		210		,, Profit and Loss Account (2) . .		235
July 31	,, Rates Adjustment Account: over-payment of Rates for the half year ended 31st January, 1953 on £200 at 15s. in £ for 4 months (1) . .		50				
			£280				£280
Aug. 1	To Balance— Rates prepaid .	b/d	45	1954 Jan. 31	By Rates prepaid (5) .	c/d	80
Nov. 1	,, Cash balance of Rates		275		,, Profit and Loss Account (4) . .		240
			£320				£320
1954 Feb. 1	To Balance— Rates prepaid (5) .	b/d	80				

Notes. (1) This item should be shown separately as it is in effect a relief in respect of the preceding period. The true rates for the period to 31st January, 1953. are £600 at 15s. in £ for 4 months = £150, which is the £200 above, less the relief in the following period.

(2) This item is arrived at as follows—

	£
Rates for 2 months (1st February, 1953, to 31st March, 1953) on £600 at 15s.	75
Rates for 4 months (1st April, 1953, to 31st July, 1953) on £600 at 16s.	160
	£235

(3) This item is arrived at—

The payment of £210 discharges £5 still owing to 31st March, 1953 (i.e. balance of [1] £80 less allowance £75) leaving £205 on account of the current rating period 1953–54. The rates in respect of the current rating period, i.e. 1st April, 1953, to 31st July, 1953, are 4 months on £600 at 16s. in £ amounting to £160 as against £205, leaving £45 prepaid.

(4) This item is half-year's rates, viz., £600 for 6 months at 16s. in £ = £240.

(5) This item is £600 for 2 months at 16s. in £ = £80 being the prepayment of 1953–54 rates, i.e. paid up to 31st March, 1954.

[1] Half-year's Rates, £800 at 15s. in £ = £300, less Cash paid £220.

The identical result would ensue if the Rates expenditure were passed through an Expenses Day Book.

(7) On 1st April, 1952, Hardcastle Ltd., whose financial year ends on the 30th June, took out a policy with Crag Insurance Co., Ltd., to cover Employer's Liability for the year ended 31st March, 1953.

The premium was at the rate of 10s. per cent of wages paid during the year covered. As the current wages cannot be ascertained till 31st March, 1953, the premium was to be calculated on the wages paid for the year ended 31st March, 1952, and an adjustment to the premium on current year's wages was to be effected by a balance payment to or by Crag Insurance Co., Ltd. on the 25th April, 1953.

On 1st April, 1953, the insurance was renewed under similar conditions (i.e. *pro tem.* on 1952/3 wages, adjusted on 25th April, 1954, to actual 1953/4 wages and cash paid to or by the Insurance Company) except that the premium was to be £1 per cent of wages paid for the year covered.

The wages paid were:—

	£
Year ended 31st March, 1952	60,000
Three months ended 30th June, 1952 . .	15,000
Nine months ended 31st March, 1953 . .	41,000
Three months ended 30th June, 1953 . .	25,000

Journalize the entries (except cash) to record the transactions and the closing entries on 30th June, 1952 and 1953, in the books of Hardcastle Ltd.

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			£	£
1952 Apr. 1	Employer's Liability Insurance Suspense . *Dr.* To Crag Insurance Co., Ltd. . . . . Premium for 1952–3 on wages for year ended 31st March, 1952: $\frac{1}{2}\%$ on £60,000		300	300
June 30	Employer's Liability Insurance[1] . . *Dr.* To Employer's Liability Insurance Suspense . . . . . . Transfer of proportion of premium for 3 mos. ended 30th June, 1952: $\frac{1}{2}\%$ on £15,000.		75	75
1953 Apr. 1	Employer's Liability Insurance Suspense . *Dr.* To Crag Insurance Co., Ltd. . . . . Premium for 1953–4 on wages for year ended 31st March, 1953: 1% on £56,000.		560	560

[1] This item will be transferred to Profit and Loss Account.

JOURNAL—(*contd.*)

			£	£
1953 Apr. 25	Crag Insurance Co., Ltd. . . . . Dr.		20	
	To Employer's Liability Insurance Suspense			20
	Refund due in respect of premium for 1952–3 on adjustment to actual (½% on £56,000 as against provisional £60,000).			
June 30	Employer's Liability Insurance[1] . . . Dr.		455	
	To Employer's Liability Insurance Suspense			455
	Transfer of premium for year ended 30th June, 1953:			
	9 mos. to 31st March, 1953—½% on £41,000 . . . . . . £205			
	3 mos. to 30th June, 1953—1% on £25,000 250			
	£455			

It will be seen that the insurance suspense account will be cleared each 25th April, but on the 30th June of each year the balance thereon will be carried forward as an asset. If each year's suspense account is kept separate, the clearance will become more apparent—

Dr. E L I. SUSPENSE (1) *Cr.*

			£				£
1952 Apr 1	To Crag Insurance Co. .		300	1952 June 30	By E.L.I.		75
					„ Balance	c/d	225
July 1	To Balance	b/d	225[2]	1953 Mar 31	By E L I		205
				Apr. 25	„ Crag Insurance Co. .		20

Dr E L I SUSPENSE (2) *Cr.*

			£				£
1953 Apr. 1	To Crag Insurance Co. .		560	1953 June 30	By E L I. . . .		250
					„ Balance . . .	c/d	310
July 1	To Balance . .	b/d	310[2]				

Dr. E L I. *Cr*

			£				£
1952 June 30	To E.L.I. Suspense (1)		75	1952 June 30	By Profit and Loss A/c		75
1953 Mar 31	To E L I. Suspense (1)		205	1953 June 30	By Profit and Loss A/c		455
June 30	„ E.L.I. Suspense (2)		250				

[1] See note [1] on previous page

[2] These items appear in the Balance Sheet as assets

(8) Included in the Trial Balance of Trader are the following—

Purchases (including Samples £1,050) at invoice price	£22,050
Sales (including £800 of goods out on Sale or Return)	17,600

The arrangement between Trader and Supplier is that the latter finances the former and supplies him with all goods at ordinary price plus 5 per cent, no discount being allowed.

Trader decided that 25 per cent of the goods out on Sale or Return should be regarded as sold.

The Stock of goods and samples on hand at the date of the Trial Balance at invoice price was £5,208. £200 of the samples purchased have been used and it was decided to write down the remainder, i.e. those on hand, by 25 per cent.

The Gross Profit, before allowing for samples used and Cost of Finance, uniformly earned is 10 per cent of selling price.

Show Trading Account, and write up accounts for Purchases, Sales, Samples and Cost of Finance.

Dr. TRADING ACCOUNT *Cr.*

		£			£
To Purchases		20,000	By Sales		17,000
,, Samples used		200	,, Stock		4,700[2]
,, Gross Profit[1]		1,500			
		£21,700			£21,700

[1] Gross Profit before charging samples and Finance = £1,700 = 10% of £17,000.

[2] Calculation of Stock—

	£	£
Goods and Samples at invoice price		5,208
Add Goods "out"		
Selling price	600	
Less 10% G P.	60	
	540	
Add 5% Finance	27	
		567
		5,775
Less Samples at invoice price		
Ordinary cost	800	
Add 5% Finance	40	
		840
Goods at invoice price		4,935
Less 5/105		235
		£4,700

Alternative calculation—

	£	£
Goods and Samples at invoice price		5,208
Less Finance Cost:		
5/105 × £5,208		248
		4,960
Add Goods "out"	600	
Less 10% G.P.	60	
		540
		5,500
Less Samples at ordinary cost (i e. excluding Finance Cost)		800
		£4,700

Generally speaking, this method takes slightly less time than the other

Dr. PURCHASES *Cr.*

		£			£
To Sundries . .		22,050	By Samples . .		1,050
			,, Finance . .		1,000
			,, Trading Account.		20,000
		£22,050			£22,050

Dr. SALES *Cr.*

		£			£
To Goods on Sale or Return . .	c/d	600	By Sundries . .		17,600
,, Trading Account .		17,000			
		£17,600			£17,600
			By Goods on S. or R.	b/d	600

Dr. SAMPLES *Cr.*

		£			£
To Purchases . .		1,050	By Finance . .		50
			,, Trading Account		200
			,, P. & L. Account .		200
			,, Balance . .	c/d	600
		£1,050			£1,050
To Balance . .	b/d	600			

Dr. FINANCE *Cr.*

		£			£
To Purchases . .		1,000	By Balances.		
,, Samples . .		50	Goods—		
			5% of £4,700 .	c/d	235
			Samples—		
			5% of £600 .	c/d	30
			,, P. & L. Account .		785[1]
		£1,050			£1,050
To Balances:					
Goods . .	b/d	235			
Samples . .	b/d	30			

[1] £785 is made up of—

	£
Ordinary cost of goods used: £20,000 — £4,700 . .	15,300
Ordinary cost of samples used and written off . .	400
	£15,700
5% thereof	£ 785

The following problem involves more intricate adjustments than those outlined in the preceding pages.

Illustration. The following is the list of balances extracted from the books of X, a trader, at 15th December, 1952 (after the Trading Account had been prepared)—

	£
Gross Profit	3,200
Rates	80
Rents Received	42
Property (England)	2,000
Plant	1,500
Investments	1,100
Dividends on Investments Received	49
Dividends on Investments Accrued	8
Removal Expenses	200
Travelling Expenses	470
Travellers' I.O.U.'s	100
Property (U.S.A.) \$5,357 at 4.87	1,100
Electricity	20
Electricity Deposit	2
Debtors—	
English	4,450
U.S.A. \$400 at 4	100
Portuguese Escudos 50,000 at 100	500
Canadian \$1,000 at 4	250
General Expenses	458
Creditors	1,720
Bad Debts (written off)	368
Drawings	700
Discounts Allowed	394
Discounts Received	395
Bank (*Dr.*)	550
Telephone Charges	32
Stock	2,000
Exhibition Expenses	242
Exchange Reserve	130
Investments Provision	280
Provision for Depreciation (Property and Plant)	600
Bad Debts Provision	200
Capital *less* Drawings	9,300

Prepare from the above balances a Trial Balance, and a Profit and Loss Account for the year ended, and a Balance Sheet as on, 15th December, 1952, after making adjustments for the following—

(1) Rates prepaid, £5.

(2) Increase Provision for Depreciation to 25 per cent of the combined value of the English and U.S.A. property and plant.

(3) Removal Expenses $\frac{3}{5}$ to be carried forward.

(4) A cheque for £60 was given on 2nd January, 1953, to recoup the travellers for their expenses, £47 of which was incurred before 15th December.

(5) Exchange Reserve to be adjusted to revalue foreign assets and liabilities at the following rates of exchange—

U.S.A.	2 80
Canada	2·80
Portugal	80
Switzerland	12

(6) Among the Creditors is included a debt due to Herr Froppan amounting to 2,000 Swiss francs at 20 to the £ payable in Swiss francs.

(7) The Canadian debt is payable in sterling.

(8) Under arrangement made at the commencement of the financial year the installation of electricity is to be paid for by the addition of 1d. a unit to the electricity bill till 5,000 units are paid for, the normal charge being 4d. a unit. The charge in the accounts (including the above-mentioned penny per unit) is to 12th October, 1952. Units consumed from 12th October, 1952, to 15th December, 1952, are 200.

(9) The Telephone Account includes the charge to 30th September, 1952. The charge for the December quarter represents 230 calls at 2d. (of which 25 were made subsequent to 15th December), as well as a charge for increase of deposit from £1 10s. to £3, the extra £1 10s. being included in this year's accounts.

So far no Telephone Deposit Account has been opened.

(10) Investments are to be brought into the accounts at £917, having regard to the fact that a dividend of £10, received after a purchase during the year, was included in the price paid.

The balance of the Investments Provision is to be carried to Profit and Loss Account.

(11) Y, a debtor, is shown in the books for £300, but during the year he assigned his Life Policy (for £500) in complete settlement. The policy at the time of the transfer was worth £170 and at 15th December, 1952, £185. A premium of £20 was paid by X and charged to General Expenses. The balance of Y's Account is to be written off to the Profit and Loss Account.

(12) Included in the debtors is £300 owing by A and in the creditors £200 owing to A. The latter is to be set off against the former both for Bad Debts and for Discounts.

(13) Adjust the Bad Debts Provision to 20 per cent of the English Debtors, and provide for discounts at 3 per cent on all debtors, and 2½ per cent on creditors.

(14) On 16th December, 1952, the bank notified the dishonour of a cheque paid by a customer £97 (the discount allowed amounted to £3).

(15) Rents accruing on property let £10.

(Calculations, except those arising out of (8) and (9) to be made to nearest £. Ignore tax.)

X

Trial Balance as at 15th December, 1952

		Dr.	Cr.
		£	£
Gross Profit			3,200
Rates		80	
Rents Received			42
Property (England)		2,000	
Plant		1,500	
Investments		1,100	
Dividends Received			49
Removal Expenses		200	
Travelling Expenses		470	
Travellers' I.O.U.'s		100	
Property (U.S.A.)		1,100	
Electricity		20	
Electricity Deposit		2	
Debtors—	£		
English	4,450		
U.S.A.	100		
Portuguese	500		
Caandian	250		
		5,300	
General Expenses		458	
Creditors			1,720
Bad Debts		368	
Discounts Allowed		394	
Discounts Received			395
Bank		550	
Telephone		32	
Stock		2,000	
Exhibition Expenses		242	
Exchange Reserve			130
Investments Provision			280
Provision for Depreciation			600
Bad Debts Provision			200
Capital			9,300
		£15,916	£15,916

Notes. (1) Drawings (£700) have already been debited against capital so that the item is ignored.

(2) Dividends Accrued £8. This is *not* a balance because the Dividends RECEIVED Account has not been credited with the accrual. If the latter account had been credited with Dividends RECEIVED and ACCRUED it would have been £57 in place of the £49, and the Dividend Accrued Account £8 as an asset.

X

Balance Sheet as at 15th December, 1952

	£	s.	d.	£	s.	d.
Capital at 16th December, 1951	10,000	0	0			
Less Drawings	700	0	0			
	9,300	0	0			
Add Net Profit per Profit and Loss Account	52	9	2			
				9,352	9	2
Exchange Reserve				1,044	0	0
Current Liabilities—						
Sundry Creditors	1,587	0	0			
Less Discount Provision	40	0	0			
				1,547	0	0
Expenses accrued.						
Travelling	47	0	0			
Telephone (£1 14s. 2d + £1 10s)	3	4	2			
Electricity £3 6 8						
Electric Fittings 16 8	4	3	4			
				54	7	6
			£	11,997	16	8

	£	s.	d.	£	s.	d.
Fixed Assets—						
Property (U S A)	1,913	0	0			
Property (England)	2,000	0	0			
Plant	1,500	0	0			
	5,413	0	0			
Less Depreciation	1,353	0	0			
				4,060	0	0
Electric Fittings				4	16	8
Investments				917	0	0
				4,981	16	8
Current Assets—						
Policy on Life of Y (Surrender Value)	185	0	0			
Deposit: Electricity	2	0	0			
Telephone	3	0	0			
				190	0	0
Stock in hand	2,000	0	0			
Debtors (as per Schedule)	4,130	0	0			
Accruals Rents	10	0	0			
Dividends	8	0	0			
Prepayments Rates	5	0	0			
Cash at Bank	453	0	0			
Cash in hand (Travellers)	100	0	0			
				6,706	0	0
Deferred Revenue Expenditure—						
Removal Expenses	200	0	0			
Less written off	80	0	0			
				120	0	0
			£	11,997	16	8

X

Profit and Loss Account for the Year Ended 15th December, 1952

Dr. *Cr.*

	£	s.	d.			£	s.	d.
To General Expenses	438	0	0	By Gross Profit	b/d	3,200	0	0
,, Electricity	19	6	8	,, Rents receivable		52	0	0
,, Travelling Expenses	517	0	0	,, Dividends (received and accrued)		47	0	0
,, Rates	75	0	0	,, Investments Provision no longer required		107	0	0
,, Telephone	32	4	2					
,, Bad Debts	1,108	0	0					
,, Discounts	84	0	0					
,, Depreciation	753	0	0					
,, Life Policy	5	0	0					
,, Exhibition Expenses	242	0	0					
,, Removal Expenses	80	0	0					
,, Net Profit transferred to Capital Account	52	9	2					
	£3,406	0	0			£3,406	0	0

Schedule of Debtors

	£	£
Debtors (England) (see below)		4,050
Less Bad Debts Provision 20%		810
		3,240
Debtors (U.S.A.) [100 + 43]	143	
(Portugal) [500 + 125]	625	
(Canada)	250	
		1,018
		4,258
Less Discounts Provision, 3%		128
		£4,130

Dr. **Depreciation** *Cr.*

			£				£
1952 Dec. 15	To Balance	c/d	1,353	1951 Dec. 16	By Balance	b/d	600
				1952 Dec. 15	,, Profit and Loss Account		753
			£1,353				£1,353
				Dec. 16	By Balance	b/d	1,353

Dr. **Removal Expenses** *Cr.*

			£				£
1951 Dec. 16	To Balance	b/d	200	1952 Dec. 15	By Profit and Loss Account		80
					,, Balance	c/d	120
			£200				£200
1952 Dec. 16	To Balance	b/d	120				

Dr. **Exchange Reserve** *Cr.*

1952			£	1951			£
Dec. 15	To Creditors (Swiss) .		67	Dec. 16	By Balance . . .	b/d	130
	,, Balance . . .	c/d	1,044	1952 Dec. 15	,, Property (U.S.) . £813		
					,, Debtors (U.S.) . 43		856
					,, Debtors (Portugal) .		125
			£1,111				£1,111
				Dec. 16	By Balance . . .	b/d	1,044

Dr. **Dividends Receivable** *Cr.*

1952			£	1952			£
Dec. 15	To Investments Account .		10	Dec. 15	By Sundries (per Trial Balance) . .		49
	,, Profit and Loss Account . .		47		,, Accrual . . .	c/d	8
			£57				£57
Dec. 16	To Accrual . . .	b/d	8				

Dr. **Investments** *Cr.*

1951			£	1952			£
Dec. 16	To Balance . . . (including purchases to 15th December, 1952)	b/d	1,100	Dec. 15	By Dividends Account .		10
					,, Investments Provision . . .		173
					,, Balance .	c/d	917
			£1,100				£1,100
1952							
Dec. 16	To Balance . . .	b/d	917				

Dr. **Investments Provision** *Cr.*

1952			£	1951			£
Dec. 15	To Investments Account .		173	Dec. 16	By Balance . . .	b/d	280
	,, Profit and Loss Account . .		107				
			£280				£280

Dr. **English Debtors** *Cr.*

1952			£	1952			£
Dec. 15	To Sundries		4,450	Dec. 15	By Life Policy Transferred		170
	,, Bank: Cheque Dishonoured and Discount . . .		100		,, Bad Debts Account .		130
					,, Creditors . . .		200
					,, Balance . . .	c/d	4,050
			£4,550				£4,550
Dec. 16	To Balance . . .	b/d	4,050				

Dr. **CREDITORS** *Cr.*

1952 Dec. 15	To Debtors . . .		£ 200	1951 Dec. 16	By Balance . . .	b/d	£ 1,720
	,, Balance . . .	c/d	1,587	1952 Dec. 15	,, Exchange Reserve (Froppan) . .		67
			£1,787				£1,787
				Dec. 16	By Balance . . .	b/d	1,587[1]

Dr. **U.S.A. PROPERTY** *Cr.*

1951 Dec. 16	To Balance . . .	b/d	£ 1,100	1952 Dec. 15	By Balance . . .	c/d	£ 1,913
1952 Dec. 15	,, Exchange Reserve .		813				
			£1,913				£1,913
Dec. 16	To Balance . . .	b/d	1,913				

Dr. **BAD DEBTS** *Cr.*

1952 Dec. 15	To Bad Debts (per Trial Balance)	£ 368		£	1951 Dec. 16	By Provision . . .	b/d	£ 200
	,, Debtor (Life Policy) . .	130			1952 Dec. 15	,, Profit and Loss Account . .		1,108
				498				
	,, Balance . .		c/d	810				
				£1,308				£1,308
					Dec. 16	By Provision . . .	b/d	810

Dr. **DISCOUNTS** *Cr.*

1952 Dec. 15	To Sundries (per Trial Balance)		£ 394	1952 Dec. 15	By Sundries (per Trial Balance) . .		£ 395
	,, Balance . . .	c/d	128		,, Debtor (Dishonoured Cheque) . .		3
					,, Balance . . .	c/d	40
					,, Profit and Loss Account . .		84
			£522				£522
Dec. 16	To Balance . . .	b/d	40	Dec. 16	By Balance . . .	b/d	128

Dr. **TELEPHONE** *Cr.*

			£	s.	d.				£	s.	d.
1952 Dec. 15	To Sundries (per Trial Balance)		32	0	0	1952 Dec. 15	By Telephone Deposit Account . .		1	10	0
	,, Accrual . .	c/d	1	14	2		,, Profit and Loss Account . .		32	4	2
			£33	14	2				£33	14	2
						Dec. 16	By Accrual . .	b/d	1	14	2

[1] Provision thereon at 2½ per cent = £40. (See Discounts Account.)

Dr. TELEPHONE DEPOSIT *Cr.*

			£	s.	d.				£	s.	d.
1952 Dec. 15	To Telephone Account		1	10	0	1952 Dec. 15	By Balance . .	c/d	3	0	0
	,, Accrual . .	c/d	1	10	0						
			£3	0	0				£3	0	0
Dec. 16	To Balance . .	b/d	3	0	0	Dec. 16	By Accrual . .	b/d	1	10	0

Dr. ELECTRICITY *Cr.*

			£	s.	d.				£	s.	d.
1952 Dec. 15	To Cash . . .		20	0	0	1952 Dec. 15	By Profit and Loss Account . .		19	6	8
	,, Accrual . .	c/d	4	3	4		,, Fittings Account.		4	16	8
			£24	3	4				£24	3	4
						Dec. 16	By Accrual . .	b/d	4	3	4

Dr. ELECTRIC FITTINGS *Cr.*

			£	s.	d.				£	s.	d.
1952 Dec. 15	To Electricity Account		4	16	8						

Dr. LIFE POLICY *Cr.*

			£	s.	d.				£	s.	d.
1952 Dec. 15	To Y		170	0	0	1952 Dec. 15	By Profit and Loss Account . .		5	0	0
	,, General Expenses		20	0	0		,, Balance . .	c/d	185	0	0
			£190	0	0				£190	0	0
Dec. 16	To Balance . .	b/d	185	0	0						

Notes. It should be noted that the Electric Fittings Account can be treated in another way. The total liability in respect of electric fittings (i.e. 5,000 pence = £20 16s. 8d.), may be entered in the books as an asset, a liability being entered in the books for a similar amount. As the fittings are paid for, in the quarterly instalments, the amounts will be posted to the debit of the latter account.

The Asset Account in the Balance Sheet may be shown, less the liability, or they may both be stated separately on opposite sides of the Balance Sheet.

In this case where the total liability is already in the books, it will naturally not be necessary to provide for the amount accrued due for payment, it being already provided for.

Dr. ELECTRICITY BOARD *Cr.*

			£	s.	d.				£	s.	d.
1952 Dec. 15	To Cash . . .		4	0	0	1952 Dec. 15	By Electric Fittings .		20	16	8
	,, Balance . .	c/d	16	16	8						
			£20	16	8				£20	16	8
						Dec. 16	By Balance . .	b/d	16	16	8

Dr.	ELECTRIC FITTINGS					*Cr.*
		£	s.	d.		
1952 Dec. 15	To Electricity Board	20	16	8		

The accounts in the Balance Sheet may appear—

	£ s. d.	£ s. d.
Electric Fittings	20 16 8	
Less Amount owing	16 16 8	
		4 0 0

or be shown separately on opposite sides of the Balance Sheet.

It will be observed that the net result of the entries in the books is precisely the same as in the original Balance Sheet, viz.—

	£ s. d.	£ s. d.
Electric Fittings	4 16 8	
Less Amount owing	16 8	
		4 0 0

The Depreciation charge is arrived at as follows—

	£	£
Property (England)		2,000
Property (U.S.)	1,100	
Add increase in value . . .	813	
		1,913
Plant		1,500
		£5,413
Provision 25% thereon		1,353
Already provided		600
Charge to Profit and Loss Account .		£753

The £200 owing to and by A being a contra item must be eliminated from Debtors for the purpose of calculating the Bad Debts Provision, as the debt is covered by the contra. However, for the purpose of computing the Discounts Provisions the contra item, £200, might be included in both Debtors and Creditors—particularly as the amount provided on Debtors (3 per cent) differs from that provided on Creditors (2½ per cent).

It must be observed that the Bad Debts Provision on the English Debtors cannot be computed until the Debtors figure has been subjected to the other adjustments required. The corrected balance of £4,050 is ascertained, as shown in the English Debtors Account.

The items in the Profit and Loss Account need not be shown in precisely the order shown above. This matter is considered on the next page. The amount brought in from Investments Provision is not really a profit of the year and, if desired, the Profit and Loss Account could be balanced off before crediting this item so as to show the true net profit for the year.

As regards the items in the Balance Sheet, the Assets and Liabilities are grouped under appropriate headings (see page 134). Reserves and Capital are, in the accounts of sole traders and partnerships, sometimes found at the foot of the Liabilities side of the Balance Sheet.

Subdivision of the Profit and Loss Account. Various views are found as to the most suitable subdivision of the Profit and Loss Account. The most important methods of arrangement are set out below—

(1) Separation of Trading from Profit and Loss Account or Section.

(2) As in (1), with a further subdivision of the Profit and Loss Account or Section into (*a*) Commercial and (*b*) Financial.

(3) As in (1) or (2), with a further extension for the appropriation of the Profit.

Sequence of Items in the Profit and Loss Account. As regards the order of items on the debit side—the credit side will be built up similarly, substituting gains for charges and costs—the following alternatives are met with—

A. (1) Current Fixed Charges—usually comprising those charges that must necessarily be incurred whilst the business is in existence.

(2) Depreciation.

(3) Losses—as distinct from Charges—incurred, e.g. Bad Debts, Exchange losses, etc.

(4) Expenses in relation to Capital—e.g. Interest on Loans.

B. (1) Normal Charges, subdivided into (*a*) Charges of an exact nature, (*b*) Charges of an approximate nature, and (*c*) Losses.

(2) Abnormal Charges.

The above are often dealt with according to their being recurring or non-recurring.

C. (1) Charges common to all businesses.

(2) Charges common to all businesses of the type under review.

(3) Charges peculiar to the particular business under review.

(4) Exceptional Charges.

(5) Losses.

D. (1) Relating to Premises—e.g. Rent.

(2) Administration.

(3) Selling Wages and Commission of Travellers.

(4) Distribution and Despatch.

(5) Finance—Discounts, Interest.

Usually, capital expenses written off are placed either last in the Profit and Loss Account (or Section) or in the Profit and Loss Appropriation Account (or Section).

Whatever method of subdivision and sequence is adopted, it is of paramount importance that the treatment should be consistent, so that, for instance, the rates of Gross Profit may be compared from period to period; and that whenever items of an unusual nature appear in the accounts, their inclusion and amount can be readily seen.

BALANCE SHEET

The effects upon the Balance Sheet of the various adjustments have been shown during the progress of this chapter, and consequently it will be only necessary to deal with one other important matter, namely, the sequence of the items.

Sequence. The Balance Sheet lends itself much more readily than does the Profit and Loss Account to a natural sequence of presentation of items. No two Balance Sheets will follow precisely the same order, but it is usual to set out assets and liabilities either—

(*a*) In order of permanence, or
(*b*) In order of liquidity.

Generally speaking, (*a*) is most commonly used by industrial and commercial businesses, (*b*) by banks and concerns of a similar nature.

In order to comprehend the rule, a clear conception of the various terms applied to assets and liabilities is necessary.

Assets are designated under the following headings—

1. Fixed. 2. Floating or Current. 3. Fictitious.

Fixed Assets may be regarded as those assets of a business which are of a permanent nature, and are definitely held for the purpose of earning revenue and not with a view to resale, e.g. Plant and Machinery, Buildings. Assets of a wasting nature are sometimes included under a separate heading, but this distinction is hardly necessary, as they are really Fixed Assets, which by their nature depreciate rapidly in value or content. Assets may be further subdivided into Tangible and Intangible, but it must be borne in mind that the latter are not necessarily fictitious. Goodwill, for example, provided it is represented by actual value, is definitely a fixed asset, notwithstanding its intangibility.

Floating or Current Assets may be regarded as those assets which are made or acquired and merely held for a short period of time, with a view to sale at a profit in the ordinary course of business; that is to say, they are easily convertible into cash, e.g. Cash, Debtors, Stock, Bills Receivable.

Fictitious Assets are merely debit balances not written off; that is, items of expenditure or losses of an unusual character which are not recoupable: Preliminary Expenses of a Limited Company, property lost through confiscation and not yet written off, Removal Expenses carried forward, etc.

The modern practice is to dispense with the general headings of "assets" and "liabilities" and to arrange the assets and liabilities in groups with appropriate headings and with sub-totals to show the amount of (1) fixed assets, (2) current assets, (3) current liabilities, (4) long-term liabilities, and (5) proprietor's interest. By making use of these arrangements the comparison of assets and liabilities is facilitated.

Where the order of permanence is chosen, the Fixed Assets will come first, usually commencing with Land and Buildings, Plant and Machinery, and so on (Goodwill, however, is often placed first), followed by the Current Assets in order of realizability ending with Cash. In the liquidity order, on the other hand, the reverse is followed, the most liquid (i.e. Cash) being taken first, the remainder following in descending order of liquidity. Fictitious Assets, which are obviously not assets at all but merely debit balances not yet written off, will in either case appear at the bottom of the list.

Liabilities should as far as possible be placed in the same order as the assets. Thus, where the permanence order is chosen, Capital, Reserves and undistributed profits—comprising the proprietor's interest—will come first, followed by Long-term Liabilities (Mortgages, Debentures, etc.) and Current Liabilities and Provisions.

BALANCE SHEET AS AT..........[1]

	£	£			£	£
Capital		15,000	Fixed Assets—			
Current Account		3,350	Land and Buildings:			
			(1) Freehold		2,000	
		18,350	(2) Leasehold		3,000	
Loan on Mortgage		6,000				5,000
Current Liabilities—			Plant and Machinery		2,500	
Sundry Creditors	1,950		*Less* Depreciation at 10%		250	
Bills Payable	1,800					2,250
Accruals: Rent etc.	750		Furniture and Fittings		1,500	
Bank Overdraft	2,000		*Less* Depreciation at 5%		75	
Mortgage Interest accrued	150					1,425
		6,650	Goodwill		2,000	
			Secret Processes		2,000	
			Patents and Trade Marks		1,000	
						5,000
			Investments:			
			Quoted		2,750	
			Not quoted		1,000	
						3,750
			Current Assets—			
			Stock:			17,425
			Raw Materials	£2,250		
			Finished Goods	1,400		
			Work in Progress	725		
			Goods on Consignment	500		
			Stationery	125		
					5,000	
			Sundry Debtors	£2,750		
			Less Bad Debts Prov.	450		
				2,300		
			Less Discounts Provision	100		
					2,200	
			Bills Receivable		575	
			Prepayments:			
			Advertising	£ 180		
			Insurance	108		
			Rates	12		
					300	
			Cash in hand	£ 15		
			Cash at Bank:			
			Deposit	2,500		
			Current	485		
					3,000	
			Fictitious Assets—			11,075
			Property in X land confiscated but not written off			2,500
		£31,000				£31,000

[1] See notes on page 136.

The principles outlined on page 134 relate to ordinary concerns and do not apply to certain companies whose Balance Sheets are required by law to conform with a set layout; in the case of limited companies, certain requirements are laid down by the Companies Act, 1948, relating to the Balance Sheet, not so much in relation to sequence as to disclosure of specific details. These requirements are dealt with in Chapter XXIII. In addition the attention of the reader is directed to the Recommendations of the Institute of Chartered Accountants on the Form of the Balance Sheet and Profit and Loss Account of industrial and commercial companies and a booklet issued by the Institute entitled "The Companies Act, 1947." It will be realized that no such form is laid down for partnerships and sole traders, but it is considered that, as far as possible, their accounts should follow the same principles.

On page 135 is set out an illustration of a Balance Sheet constructed on the "Permanence" principle, but it should always be borne in mind that there are considerable variations and modifications according to the nature of the business, the particular purpose of the Balance Sheet, and the wishes of the proprietor.

Notes. (1) The question as to whether investments are fixed or current assets is sometimes difficult to determine, but, generally speaking, investments in affiliated companies are classified as fixed assets. Short-term investments, however, may be regarded as current assets as they are merely a substitute for cash.

(2) In the case of stock the basis of valuation should be clearly indicated; that is, whether it is taken at cost or market price, etc.

(3) Where prepaid expenses represent payment for services to be performed in the future, they may be treated as current assets.

(4) It is usual to subdivide investments into those quoted on the Stock Exchange and those not quoted, the former being more easily realizable than the latter.

(5) It will be noticed that whereas ordinary liabilities such as loans, creditors, etc., appear on the left-hand side of the Balance Sheet, certain credit balances in the nature of reserves or provisions, e.g. Bad Debts, are often deducted from the particular asset to which they refer.

(6) Instead of deducting depreciation for the year from the fixed assets balance brought forward and carrying forward the new balance, as is done in this illustration, the fixed assets may be shown at cost (or valuation) less the aggregate of the provisions for depreciation to date (*vide* Chapter XXIII for the requirements of the Companies Act, 1948, in this respect).

There are many alternative methods of presentation. In one method the proprietor's interest is shown on the left-hand side and the net assets, subdivided, on the right-hand side. This method lends itself particularly to presentation in columnar form, as shown in the following abbreviated example—

BALANCE SHEET AS AT ....

	£	£
Current Assets	7,000	
Less Current Liabilities	3,100	
		3,900
Add Fixed Assets		3,100
		7,000
Less Long-term Liabilities		2,200
		£4,800
Representing—		
Issued Share Capital		£4,000
Reserves and undistributed profits		800
		£4,800

General Survey. From the aspect of examination work the following matters are worthy of the most careful attention:—

(1) The *Nature* of the business; e.g. if an extractive business like a quarry, attention will be directed to depletion; if an exporter, to the question of foreign exchange.

(2) The *Period* covered by the accounts. The matters most usually affected by the period are Depreciation, Loan Interest, Partners' Salaries and Interest on Capital, Investment Income; on the other hand, the Provision for Bad Debts will not be affected thereby as it depends upon the amount of Debtors at a particular date.

(3) Provision should be made for expenses and charges accrued and accruing where possible. Should no information be disclosed in the question, a footnote should be made. On the other hand, appropriations of profit and "prudent" (as distinct from compulsory) reserves should not be made, but the matters relegated to a footnote. For instance, Loan Interest paid for six months only in a twelvemonth period (or indeed any period longer than six months) will indicate the necessity for provision in the accounts for interest accrued or accruing; or in the less frequent instance an adjustment in respect of a payment in advance. Care must be taken to note any change in the amount of the Loan or in the rate of interest in respect of the period not covered exactly by the payment, e.g. by a repayment of principal. Depreciation will be provided for if the rate of depreciation is given, but not otherwise.

(4) If an item paid in advance or accruing appears in the Trial Balance, that is if it is a BALANCE, the Double Entry will already have been made. Frequently the wording of the question will serve as a guide; thus "Rent paid and outstanding" clearly indicates that the provision for Rent accruing has been made so that the latter item is a balance. Likewise Depreciation may be a balance if the Asset to which it relates is "NET, after Depreciation."

Otherwise adjustment items are not part of the Trial Balance or if inserted must appear twice, once as a debit and once as a credit.

Stock on hand (if closing) will, by the same rule, be (*a*)

either a balance (after the Trading Account has been closed off), in which case the Trading Account balance—usually credit—will appear in the Trial Balance; or (*b*) an adjustment item requiring crediting to Trading Account and insertion in the Balance Sheet as an Asset. In this case the Opening Stock, Purchases, Sales and other Trading items will all appear in the Trial Balance as the Trading Account will not have been closed off.

(5) Items which may properly appear either as a debit or as a credit must be carefully scrutinized, particularly as there may, notwithstanding errors, be agreement of the Trial Balance. Bank Interest, Discounts, Bank, Profit and Loss balance forward are typical.

On the other hand, certain items inevitably indicate incorrectness of accounting, e.g. credit balance on Cash Account, credit balance on Short Workings in Royalties (as will be noticed in Chapter XV). But a credit balance on an Investment (Asset) Account or a debit balance on a Bad Debts Provision Account indicates not so much incorrectness as incompleteness of the accounting, the former involving a profit on sale of investment and a consequential transfer; the latter an incurring of bad debts of an amount larger than the existing provision. A transfer to Bad Debts Account (usually after creating the new Bad Debts Provision) is required, but the fact of there being a debit balance on the old account will not necessarily mean that the provision was inadequate, because the account may include bad debts incurred since the date of the provision.

(6) Goods acquired in connection with expenses—and similarly stock on hand—must be dealt with in the appropriate account, and not in the Trading Account, which deals with goods bought for resale.

(7) Goods withdrawn for private purposes are not SALES. The latter account should include goods sold at SELLING prices. When the proprietor takes goods for private use he reduces his BUSINESS purchases, so that the credit is to PURCHASES, not sales. Logically, any cash discount, if identifiable, is not a business profit, and a transfer should be made to the credit of drawings.

(8) Where "no profit" sales take place (e.g. by a tobacconist to obtain the Tobacco Bonus) they should be separately shown or deducted in an inset column from general purchases.

(9) Particular care is required in "placing" debits of a "Profit and Loss" nature. It is of vital importance to distinguish between the CHARGE against, as distinct from APPROPRIATIONS of profit.

As to depreciation, where a Manufacturing Account is required there appears to be unanimity as to depreciation of machinery being charged in that account, but otherwise there appears to be a divergence of view as to whether depreciation should be charged in the Trading section or the Profit and Loss section. The proper course to adopt is to insert the charge in the latter account and state the alternative in a footnote.

(10) Where ambiguities occur or essential dates are lacking any reasonable assumption (supported by reasons) may be made,

e.g. if Interest on a Loan has to be charged, the Loan may be assumed to have been in existence at the commencement of the period; where interest on drawings has to be charged, the drawings may be assumed to have been made uniformly over the period.

(11) Frequently an adjustment will require a consequential entry, e.g. if goods sent out on sale or return have been incorrectly treated as sales, in addition to the reduction of Sales and Debtors there will be an increase of Stock at cost or market value in respect of the goods in hands of customers. In addition, such adjustment may affect the amount of Bad Debts Provision, because as a result of the correction the amount of debts is diminished. Again, if the question requires the writing off of a loss on sale of an asset, part of the debit balance on the account may be in effect depreciation.

(12) In regard to the Balance Sheet, the important matters are—

(*a*) Sequence and grouping of Assets and Liabilities.

(*b*) Deduction of provisions from the appropriate assets.

(*c*) A Bad Debts Provision is computed upon the book debts *less* contra accounts of customers, whilst the provision for discounts on debtors is based on the book debts less the Bad Debts Provision.

(*d*) Contingent Liabilities should be dealt with at the foot of the Balance Sheet in a note.

(13) Finally, mere arithmetic balancing will not gain full marks, nor will failure to balance necessarily cause serious loss of marks, so long as the PRINCIPLES involved—always present in the mind of the examiner—be adequately and intelligently dealt with. Hence, supporting schedules and computations should be attached to the answer.

So far as balancing is concerned the most frequent sources of trouble are (1) that the Trial Balance is not in agreement; (2) errors in dealing with the adjustments either by reason of omission of the double entry or by making them both debits or both credits; (3) overlooking the carry out of inset items into the main column.

The Use of Percentages in the Trading and Profit and Loss Account. Much valuable information can often be gained by comparing the accounts of one year with those of another on a percentage basis, since comparisons are more easily made on this basis than between actual money values. Unless due care is exercised, however, particularly in regard to the basis on which the percentages are made, the results may be very misleading. Thus, the usual basis from which the percentages are worked is Sales (i.e. Sales are taken as 100 per cent) but it is obvious that there can be little interest in the percentage on Sales of Purchases alone, the real figure to be taken being the cost of the goods sold, that is, opening stock plus purchases, less closing stock. Similarly, wages should be related to output, carriage inwards to purchases, and so on.

A distinction must also be made between those items which may be expected to vary with Sales and those which may be expected to remain constant. Thus, whereas the percentage of Gross Profit will normally be related to Sales, standing charges generally bear no

relation to them, so that the former will normally be variable in amount but constant in ratio, whilst the latter tend to be fixed in amount but variable in ratio. For this reason the use of percentages is often confined to the Trading Account. The term "standing charges" is, of course, only relative, e.g. there may be rising costs, etc., but even so some will remain the same, such as Rent on a long lease.

A business will seek to earn the marginal gross profit needed to cover its fixed charges, so that gross profit beyond that amount will, broadly speaking, be net profit, e.g. if standing charges are £400 per annum and the rate of gross profit 20 per cent, then the minimum net annual sales should be £2,000. Hence, if the net annual sales (assuming the same rate of gross profit) are increased to £6,000, there will be an increase of gross profit of £800 and a corresponding increase, subject to additional selling and distribution expenses, in net profit. Actually there will be included in the Profit and Loss Account some items which do vary with sales, e.g. carriage out, and, where there are credit sales, discounts allowed and bad debts, so that for this purpose these items should be brought into account in arriving at gross profit, leaving only the fixed charges to be debited against it. Naturally these fixed or standing charges may themselves vary over a period—increases in salaries, rates, etc.—but these increases are not caused by, nor have any relationship to sales.

Illustration. X intends to purchase a retail shop and has the choice of two similar ones, the comparative figures of which are—

	A Shop	B Shop
	£	£
Annual Sales	4,000	12,000
Fixed Charges	250	400

The percentage of Gross Profit is 15 per cent in both cases. Both shops are run by their owners but X intends to install a manager at £350 per annum for A or £375 for B.

Assuming that conditions remain the same and the fixed charges contain no proprietorship items, the comparative position is—

	A		B
	£		£
Gross Profit: 15% of £4,000.	600	15% of £12,000 . . .	1,800
Fixed Charges: £250 + £350	600	£400 + £375	775
	Nil		£1,025

The marginal gross profit (i.e. sufficient only to cover fixed charges) of A is £600 and of B £775. Regard will be had to the price of goodwill, stock to be carried, and working capital required. If X has insufficient funds to cover these, he will have to resort to borrowing and the cost thereof will increase the fixed charges and convert A into a losing proposition. The charge for borrowing in connection with the goodwill would be a fixed charge, whereas that in connection with stock and working capital would be a variable and should be first deducted in arriving at the marginal gross profit.

CHAPTER VI

BILLS OF EXCHANGE

It is not within the scope of this book to deal with the purely legal aspect of bills of exchange, promissory notes, and cheques, and reference will be made to the legal side only in so far as is necessary to enable the student to obtain a proper perspective of the subject.

A bill of exchange is defined in the Bills of Exchange Act, 1882, as follows—

> A bill of exchange is an unconditional *order* in writing *addressed* by one person to another, signed by the person giving it, *requiring* the person to whom it is addressed *to pay* on demand, or at a fixed or determinable future time, a sum certain in money to, or to the order of, a specified person, or to bearer. (*Sect.* 3.)

By the same Act a promissory note is defined as follows—

> A promissory note is an unconditional *promise* in writing *made* by one person to another signed by the maker *engaging* to pay on demand or at a fixed or determinable future time, a sum certain in money, to, or to the order of, a specified person or to bearer. (*Sect.* 83.)

By the same Act a cheque is defined as follows—

> A cheque is a bill of exchange drawn on a *banker*, payable on *demand*. (*Sect.* 73.)

The important distinctive words are put into italics for emphasis. Beyond stating that the law is generally similar for bills of exchange and promissory notes with certain essential differences, the present chapter will not consider the legal incidents of promissory notes, and will be exclusively confined to bills of exchange.

When a bill is drawn up it is known as "drawing" a bill and the person who draws it is the creditor (or his agent) of the person to whom it is addressed, that is the debtor; they are known respectively as the drawer and drawee, the former being the creditor, the latter the debtor. When the drawee signifies his assent to the order in writing he becomes the acceptor, and as such is liable to a holder of the bill according to the tenor thereof. The creditor or drawer may make the bill payable either to himself or to another person. Under the Bills of Exchange Act, the acceptor is always liable to pay the bill, all other parties being in the position of sureties, so that if the document has already passed through several hands (the parties having endorsed it in the same way as a cheque), the holder in whose possession it is when the bill matures (that is to say, becomes due), must, in order to safeguard and preserve his rights against the parties other than the acceptor (who is always

liable on the bill) comply with certain formalities should the bill fail to be paid at maturity.

The custom of drawing bills of exchange dates from the Middle Ages and carried, and still carries, two very important rights, viz.—

(1) It enables the holder, who is technically in law an assignee, to SUE in his OWN name, and—

(2) It entitles the holder to enforce payment "free from equities."

These two characteristics are the essentials of a NEGOTIABLE instrument—which term is a term of LAW, not of COMMERCE. Confusion exists, unfortunately, by the common employment of the term NEGOTIATION in relation to bill transactions when persons deal with, transfer, buy or sell a bill; but whilst a TRANSFERABLE document is one which may be transferred from one person to another, that is quite a different matter from its being a NEGOTIABLE document. A common example may be cited by reference to a postal order. Such a document is freely transferable, but is not a NEGOTIABLE instrument.

With reference to the first characteristic, the importance of this privilege is not so great as in the past when the Common Law did not recognize assignments of certain things, usually *choses in action*—rights which depend not on possession, but on the court's willingness to enforce them—so that the assignee had to join the name of the assignor if it became essential to enforce his rights; but the law relating to bills of exchange was gradually moulded and shaped by the law merchant which contained much foreign law through its contact with the ideas and customs of other nations. This fact, together with the practical needs of the mercantile community, led from the very outset to the rule that the assignee of a bill had the right, without being at the mercy of a capricious assignor, to go ahead with his action. In short, whether his assignor objected or not, the assignee's right to sue was, in the absence of nullifying causes, absolute.

The second characteristic is, however, of the greatest importance. The right here, as in the preceding paragraph, owed its origin to the law merchant. Provided that the holder of a bill has become technically a "Holder in due course," he may sue on the bill despite the lack, or deficiency of, title of his assignor. It is this more than any other characteristic that determines whether or not a document is a negotiable instrument. Where the assignor can bestow a better title to his assignee than he himself possesses, the instrument so passing is a negotiable instrument, subject always to the presence of good faith on the part of the assignee.

The use of bills of exchange is not confined to financing exports and imports, but extends to the home trade and the book-keeping entries follow the same principles quite irrespective of the particular purpose of the bill transaction.

The nature of a bill may be understood better by considering the following example. Suppose A owes B £1,000, the latter may draw up a bill, address it to A, and make it payable (say in three months' time) to himself (B) or even to a third party (C). After he has signed it B will in the ordinary way obtain A's acceptance. The document, as will be seen, may be transferred (very much like a cheque) or may be kept "in hand" for the three months; or may be taken to the bank for discounting.

It will be seen that should A owe B £1,000 and B owe C £1,000, and all parties agree, the one bill settles the mutual debts; that is when A accepts the bill (i.e. signifies his assent in writing thereon) B will credit A's account in the same way as if a cheque had been received; at the same time B will debit C's account as if he had paid him a cheque. A will debit B's account when he accepts the bill; the fact that the payee is C is immaterial. So far as C is concerned he will credit B just as if a cheque had passed between them and the fact that the acceptor is A is immaterial. The word "immaterial" is naturally meant to signify that the nature of the book-keeping entry is the same for C whether the acceptor is A or B. The bill comes (as between B and C) from B, and A is not one of the accounting parties: but in a business sense the standing and reputation of the acceptor of a bill is of prime importance, as C would not take the bill either as payee or as endorsee if there were doubts as to A's capacity and willingness to fulfil his written obligation, notwithstanding C's right against B should the bill be dishonoured by non-payment at its maturity.

Inland Bill. From the legal standpoint an inland bill is defined as one which is, or purports to be, drawn and payable in the British Isles *or* drawn in the British Isles on a person resident therein. All other bills are considered to be foreign for this purpose.

From the viewpoint of the Stamp Act the conceptions of inland and foreign bills are considerably different. A foreign bill is defined as a bill which is drawn and payable outside the United Kingdom, but paid, endorsed, or negotiated in the United Kingdom. All other bills from the viewpoint of stamp duty are considered as inland bills.

The significance of the above definitions is that for the purposes of determining the legal incidents of a bill of exchange (English law applying to an inland bill and foreign law to a foreign bill), one criterion is employed, and for determining the rate of stamp duty to be paid another criterion is applied.

A good example of this is that bills drawn in the Channel Islands and the Isle of Man are "legally" inland bills—within the British Isles; yet for the purposes of stamp duty they are foreign bills—outside the United Kingdom.

It is important to note that only one definition (i.e. of an inland bill) occurs in the Bills of Exchange Act, 1882; the other (i.e. of a

foreign bill) occurring in the Stamp Act, 1891, and being applicable for stamp duty purposes alone.

The stamp duty on inland bills (as defined for the specific purpose) is—

When the amount does not exceed £10				2d.
Exceeding £10	but not exceeding		£25	3d.
,, £25	,,	,,	£50	6d.
,, £50	,,	,,	£75	9d.
,, £75	,,	,,	£100	1s.

When the amount exceeds £100, 1s. for the first £100 and an additional 1s. for every £100 or fraction of £100. When bills are drawn payable on demand (which includes those payable on presentation or at sight) or within three days after date or sight, no matter what the amount, the stamp duty is only 2d.

The stamp duty on foreign bills is—

Up to £50, like an inland bill.
Exceeding £50 but not exceeding £100, 6d.
,, £100, 6d. for every £100 or fraction of £100.

The following is a specimen of an inland bill.

£1,000 LONDON,
14th January, 19..

10s. Stamp

THREE MONTHS after date pay to me (or, if arranged, "to C,") or my order the sum of *One thousand pounds*, value received.

B.

Accepted payable at Lloyds Bank, King Street, Manchester.
A.

To A, MANCHESTER.

It should be noted that B is the drawer, A the drawee (and upon acceptance, the acceptor), B (or C) is the payee.

The following are examples of foreign bills—

Exchange for £470 LONDON,
29th April, 19..

5s. Stamp.

SIXTY DAYS after sight pay this First of Exchange (Second and Third of the same date and tenor unpaid) to Messrs. *Dubois et Cie*, or order, *Four hundred and seventy pounds*, value in account.

L. F. THOMSON.

To MM. MARTIN ET CIE,
CALAIS.

£342 12s. 4d.

MANCHESTER,

30th October, 19..

4s. Stamp.

TWO MONTHS after date pay this First of Exchange (Second and Third same date and tenor unpaid) to *Fritz Troppau*, or order, the sum of *Three hundred and forty-two pounds twelve shillings and four pence*, at the rate of exchange as per first London endorsement, value received.

M. SMITH.

TO HERR F. LUDWIG,
BERNE.

Both the above bills are inland bills for stamp duty purposes.

The following are the chief advantages of a bill of exchange—

(1) It is a means of settlement of foreign debts and the financing of exports. It bridges, as it were, the gap between the date of shipment and receipt at destination. Naturally, the exporter does not wish to wait for, say, three weeks for payment in respect of his sale to a South African importer, nor does the importer feel it incumbent upon him to pay until receipt of the goods. By drawing the bill, accompanied usually by bills of lading and other documents, the exporter is able to obtain his money from his banker, who, on his part, forwards the documents to his South African agent, who will transfer the documents necessary to enable the South African importer to claim the goods upon his acceptance or payment, according to circumstances.

(2) In all cases it permits a debtor to defer payment until maturity.

(3) It is evidence of indebtedness.

(4) It enables (as has been shown) the holder in due course to sue in his own name and "free from equities."[1]

(5) It fulfils to a certain degree, in this country, the function of currency.

(6) It enables a person to "lend his name" and so finance another by means of an accommodation bill. This is not a truly legitimate and normal function of a bill of exchange.

BOOK-KEEPING ENTRIES

The position of the acceptor will first be dealt with. By his acceptance he engages to pay the required sum at the due date, but by the same act is relieved of liability to pay before such date.

[1] NOTE. A person cannot obtain a better title to goods, chattels, etc., than that possessed by the seller, subject to certain exceptions, the most important of which is a bill of exchange.

It is immaterial to him what the drawer does with the document during the interval; his retention of it in his safe, his endorsing it over to his creditor, or his obtaining a loan from the bank on its security do not interest the acceptor. The latter is concerned alone with meeting his obligation on the due date and not before.

Where bill transactions are extensive a Bills Payable Book and/or Bills Receivable Book will be used for dealing with bills accepted, and drawn or received respectively, which may be incorporated, if desired, in the double entry system. But as such book will not dispense with Journal entries, if kept on non-double entry lines, and, if so kept, will be but a Journal in modified form, for the purpose of concise explanation the entries in the examples below will be shown in Journal form (without narratives).

Where thought necessary, Ledger Accounts will be appended to supplement the explanation.

Entries in the Books of the Acceptor [i.e. the DEBTOR]

JOURNAL

Dates			£	£
Date of Acceptance	Creditor (Drawer) . . . *Dr.* To Bills Payable			
Date if and when Drawer discounts the Bill	No entry			
Due date *if paid* by Acceptor	Bills Payable[1] . . . . *Dr.* To Bank			
Due date *if dishonoured* by Acceptor	Bills Payable[1] . . . . *Dr.* To Creditor			

The first entry against the creditor is precisely the same as if a cheque had been given, so that, so far as this transaction is concerned, it balances the creditor's account, and consequently when the bill is met the acceptor will not debit the account of the creditor, but Bills Payable. If the acceptor fails to pay the bill, the original debit to the creditor must be reversed, as the acceptor has paid his creditor nothing; not only must the amount of the bill be credited back to the creditor, but with it any discount allowed to the debtor. It should be clearly grasped that whether the bill be paid or dishonoured, the original bill is dead; it has been either discharged in the normal way by payment or dishonoured by non-payment. Hence, the Bills Payable Account must be closed.

[1] Only one of these Journal entries will be made according to whether the bill is met or dishonoured.

Illustration. A owes B £1,000. On 1st January, 19.., A accepts a three months' Bill for £975 being in full settlement. At its due date the bill is met.

Entries in the acceptor's books are—

(1) *On acceptance*—

A's JOURNAL

19..				£	£
Jan. 1	B . . . . *Dr*.			1,000	
	To Bills Payable				975
	„ Discounts Received . . .				25

The payment will be recorded in the Cash Book, but in this entry and subsequent entries relating to Bills the Journal will be used.

(2) *On payment*—

A's JOURNAL

19..				£	£
April 4	Bills Payable[1] . . . . . *Dr*.			975	
	To Bank				975

(3) *If dishonoured, instead of* (2), *the entry will be*—

A's JOURNAL

19..				£	£
April 4	Bills Payable[1] . . . . . *Dr*.			975	
	Discounts Received . . . . *Dr*			25	
	To B				1,000

Unless the Bill otherwise provides, three days of grace are added to the term of all bills payable after date or after sight (but not at sight or on demand). These three days must, therefore, be taken into account in calculating the due date, and also for discount and interest. Thus, the due date of this bill is the 4th and not the 1st April, 19..

Since bills are only payable on business days, the following provisions (Section 14) apply when the third day of grace falls on a non-business day—

(*a*) If the last day of grace falls on a Sunday, Christmas Day, Good Friday, or a day appointed by Royal Proclamation as a public fast or thanksgiving day, the bill is due and payable on the preceding business day.

(*b*) If the last day of grace is a bank holiday other than the above, or if the last day of grace is a Sunday and the second day of grace a bank holiday, the bill is due and payable on the succeeding business day.

Apart from the addition, where relevant, of days of grace, the day of payment is found as follows—

(*a*) The day of payment is included and the day from which the term is to begin to run is excluded.

(*b*) "Month" means calendar month.

(*c*) A bill payable on demand, at sight or on presentation, is payable on the day of demand.

[1] The due date is 4th April, 19.., allowing for three days of grace.

Entries in the Books of the Drawer [i.e. the CREDITOR]

(1) *Where the drawer discounts the bill—*

JOURNAL

Dates		£	£
Date of Acceptance	Bills Receivable . . . *Dr.* To Debtor (Acceptor) . .		
Date if and when discounted	Bank[1] . . . . . *Dr.* To Bills Receivable . . . Discounting Charges Account *Dr.* To Bank		
Upon its due date if *paid* by Acceptor	No entry[2]		
Upon its due date *if dishonoured* by Acceptor	Debtor . . . . . *Dr.* To Bank[2]		

When it is realized that the bank is lending money for the period between the date the bill is DISCOUNTED—not necessarily the date of acceptance—and its maturity date, the justification for the charge for discounting needs no further explanation. The charge made by the banker is called banker's interest or discount as distinct from true discount. It is simply explained by the fact that the banker in discounting a bill of £1,000 for three months at (say) 5 per cent per annum will give credit to the customer for the £1,000, and at the same time debit him with discount or interest on £1,000 at 5 per cent for three months, which is £12 10s.; that is, the banker lends £1,000 – £12 10s. = £987 10s. for which he charges £12 10s. interest. If a true 5 per cent interest rate were charged, that is to say on the amount which plus interest at 5 per cent per annum for three months would amount to £1,000, the charge would be £12 6s. 11d., calculated as follows—

$$^{3}\ \frac{1\frac{1}{4}}{101\frac{1}{4}} \times £1,000 = \underline{\underline{£12\ 6s.\ 11d.}}$$

Thus interest on £987 13s. 1d. for 3 months at 5 per cent = £12 6s. 11d.

[1] It is important to keep the two entries separate, that is first the payment into the bank at its face value; and secondly the banker's charge for discounting.

[2] If the bill is met no further entry is required, because the bill has been temporarily considered as met by the preceding transaction; but if the acceptor fails to pay at the due date his account will be debited and the bank credited, as obviously the bank will debit its customer—the person who has received the bill and discounted it—hence the bank's customer will credit the bank and debit the acceptor.

[3] 5 per cent per annum for three months equals $1\frac{1}{4}$%.

Thus £12 10s. is chargeable (banker's discount) instead of £12 6s. 11d. (true discount).

The difference is slight; in this case (on the £1,000 bill) the amount is 3s. 1d. which is—

$$\frac{1\frac{1}{4}}{101\frac{1}{4}} \times £12\ 10s. = \underline{3s.\ 1d.}$$

(2) *Where the bill is "paid" away*—

When the bill receivable is transferred to a creditor of the drawer the entries are (after debiting the bills receivable account and crediting the customer upon the latter's acceptance)—

JOURNAL

Dates			£	£
When transferred	Creditor . . . . *Dr* To Bills Receivable . .			
Upon its due date *if paid* by Acceptor	No entry			
Upon its due date *if dishonoured* by Acceptor	Debtor (Acceptor of the Bill) *Dr*. To Creditor			

For reasons already mentioned, an entry will be made only if the acceptor fails to pay, when the drawer (the creditor of the acceptor) will redebit the acceptor and recredit the person to whom he assigned the bill.

(3) *Where the bill is held till maturity*—

The bill will be presented at the bank, [in fact it will be paid in on a separate slip like a cheque], the entry for which is—

JOURNAL

Dates			£	£
Due date whether Acceptor meets it or not	Bank . . . . *Dr*. To Bills Receivable .			
If met by Acceptor	No entry			
If dishonoured by Acceptor	Debtor . . . . *Dr* To Bank			

Before proceeding with the illustration, students may, at this stage, observe—

(1) That in the acceptor's books the important factors are the date of acceptance and the due date of the bill, in that any intervening transactions relating to the bill (whether discounting, or transfer, or payment into bank by the holder) are not of importance to the acceptor; nor, in the case of the bill being discounted, are the discounting charges.

(2) That in the drawer's books, the important factors are the date of acceptance, date of transfer or discounting as well as the due date of the bill, but no book-keeping entries will be required in the drawer's books at the latter date, if, having disposed of the bill by discounting or transfer, he is not notified of its dishonour.

(3) Whenever any one party has received discount (cash discount), and the bill of exchange in question is dishonoured, thus necessitating the recrediting of the Personal Account of the creditor, the cash discount must be reversed; conversely, when one party has allowed to an acceptor cash discount and the bill is dishonoured.

(4) The phrase "no entry" relates only to the ordinary books of account, so that if Bill Books are utilized suitable entries will be made therein.

Summarizing the chief points of (1) and (2) normally—

(1) There is no entry in the **acceptor's** books when the **drawer** disposes of or discounts the bill during its currency, whilst—

(2) There *is* an entry in the books of the **drawer** upon discounting or disposing of the bill, but no further entry at its due date, unless it is dishonoured.

Illustration.

Entries in the drawer's books when the bill is discounted.

A owes B £1,000; on 1st January, 19.., A accepts a three months' Bill for £975, in full settlement. Discounting charges £12 10s. 0d.

(1) Where the bill is met.

B's Journal

			£	s	d.	£	s	d.
19..								
Jan. 1	*On acceptance*—							
	Bills Receivable . . Dr		975	0	0			
	Discounts Allowed Dr		25	0	0			
	To A					1,000	0	0
	On discounting (assumed same date as acceptance)—							
	Bank . . . . . Dr		975	0	0			
	To Bills Receivable .					975	0	0
	Discounting Charges . Dr.		12	10	0			
	To Bank					12	10	0
19..								
April 4	*On being met.* No entry							

(2) Where the bill is dishonoured.

The entries will be the same as those just outlined, except as to 4th April, 19..; instead of there being "No entry" the following entry will be made—

B's Journal

			£	£
19.. April 4	*On being dishonoured*—			
	A . . . . *Dr*		1,000	
	To Bank			975
	,, Discounts Allowed . . .			25

Entries in the drawer's books when the bill is transferred to his (the drawer's) creditor.

Illustration. Same facts (as before) except that the bill is transferred to C in complete settlement of an account of £985 (1st February).

B's Journal

			£	£
19.. Jan. 1	*On acceptance*—			
	Bills Receivable[1] . . . . *Dr.*	L.	975	
	Discounts Allowed . . . . *Dr*	L.	25	
	To A	L.		1,000
Feb. 1	*On transferring bill to C*—			
	C . . . . *Dr.*	L.	985	
	To Bills Receivable . . .	L.		975
	,, Discounts Received. . .	L.		10
	[Should C discount the bill with his banker that concerns neither A nor B.]			
April 4	*On being met.* No entry.			

If, however, the bill is dishonoured at maturity, attention need only be given to the position at 4th April, 19.., the entries in the preceding example having been made.

B's Journal

			£	£
19.. April 4	A[1] . . . . *Dr.*	L.	975	
	To C	L.		975
	A . . . . *Dr.*	L.	25	
	To Discounts Allowed . . .	L.		25
	Discounts Received . . . . *Dr.*	L.	10	
	To C	L.		10

[1] See pages 152 and 153 for posting to Ledger.

These entries have the effect of—

(1) Debiting A back with £1,000.

(2) Recrediting C with £985.

(3) Cancelling the original discount received and allowed entries, resulting in a net credit of £15.

Entries in the drawer's books when the Bill is held by B till maturity—

B's Journal

				£	£
19..					
Jan. 1	*On acceptance—*				
	Bills Receivable	Dr.		975	
	Discounts Allowed	Dr.		25	
	To A				1,000
April 4	*On paying bill into bank—*				
	Bank	Dr.		975	
	To Bills Receivable . . .				975
April 4	*On being met.* No entry.				

If the bill is not met but dishonoured at maturity, instead of "No entry" there will be the following—

B's Journal

				£	£
19..					
April 4	A	Dr.		1,000	
	To Bank				975
	,, Discounts Allowed . . .				25

The postings will be made in the usual way to the Ledger, e.g. taking the entries in the drawer's books when he passed the bill on to his creditor, the bill being dishonoured. (See page 151 where Journal entries are folioed "L.")

B's LEDGER

Dr. A *Cr.*

			£				£
19..				19..			
Jan. 1	To Balance . .	b/d	1,000	Jan. 1	By Bill due 4th April, 19.. .		975
					,, Discount . .		25
			£1,000				£1,000
April 4	To Bill due this date dishonoured[1] .		975				
	,, Discount allowed written back[1] .		25				

[1] The circumstances may require the balance to be written off as bad.

Dr. **Bills Receivable** *Cr.*

19.. Jan. 1	To A: Bill due 4th April, 19..		£ 975	19.. Feb. 1	By C		£ 975

Dr. **C** *Cr.*

19.. Feb. 1	To Bill due 4th April, 19.. (Acceptor A)		£ 975	19.. ?	By Balance	b/d	£ 985
	,, Discount		10				
			£985				£985
				April 4	By Bill due this date dishonoured by A		975
					,, Discount received written back		10

Dr. **Discount Allowed** *Cr.*

19.. Jan. 1	To A		£ 25	19.. April 4	By A: Discount allowed written back		£ 25

Dr. **Discount Received** *Cr.*

19.. April 4	To C: Discount received written back		£ 10	19.. Feb. 1	By C		£ 10

General Illustration. On 1st July, 19.., Smith owes Jones £1,200 and accepts three bills of £400 each due respectively in one, two and four months. The first bill is retained by Jones and met in due course; the second is discounted (charges £2) and met in due course; the third is discounted (charges £2) and dishonoured, the noting charges being 10s. (For an explanation of noting charges, see page 155.)

New arrangements are immediately made whereby Smith pays £100 cash immediately and accepts a bill due in two months for the balance of the account with interest at 6 per cent per annum. The bill is retained by Jones till maturity. On presentment the bill is dishonoured—noting charges 5s. Smith is shortly afterwards made bankrupt, his trustee paying a first and final dividend of 5s. in £. Write up the Ledger Accounts in Jones's books.

Dr. **Smith** *Cr.*

Date			£	s	d	Date			£	s	d
19.. July 1	To Balance .	b/d	1,200	0	0	19 . July 1	By Bills Receivable due—				
							4th Aug .		400	0	0
							4th Sept .		400	0	0
							4th Nov. .		400	0	0
			£1,200	0	0				£1,200	0	0
Nov 4	To Bill due this date dishonoured .		400	0	0	Nov 4	By Cash . . .		100	0	0
	,, Noting Charges			10	0		,, Bill due 7th Jan, 19 .		303	10	1
	,, Interest for 2 mos on £300/10/0 @ 6% per annum		3	0	1						
			£403	10	1				£403	10	1
19 . Jan 7	To Bill due this date dishonoured .		303	10	1	19 . ?	By First and Final Dividend of 5s in £ on £303/15/1		75	18	9
	,, Noting Charges .			5	0	?	,, Bad Debts		227	16	4
			£303	15	1				£303	15	1

Dr. **Bills Receivable** *Cr.*

Date			£	s	d	Date			£	s	d
19 . July 1	To Smith Bills due—					19 July 1	By Bank Bills due—				
	4th Aug .		400	0	0		4th Sept		400	0	0
	4th Sept		400	0	0		4th Nov.		400	0	0
	4th Nov .		400	0	0	Aug 3	,, Bank . .		400	0	0
			£1,200	0	0				£1,200	0	0
Nov. 4	To Smith Bill due 7th Jan, 19		303	10	1	19 Jan 6	By Bank .		303	10	1

Dr. **Bank** *Cr.*

Date			£	s	d	Date			£	s	d
19 July 1	To Bill due—					19 July 1	By Discounting Charges . .		2	0	0
	4th Sept		400	0	0		,, ,, ,,		2	0	0
	4th Nov		400	0	0	Nov 4	,, Bill due by Smith dishonoured		400	0	0
Aug 3	,, Bill due 4th Aug		400	0	0		,, Noting Charges thereon .			10	0
Nov. 4	,, Smith .		100	0	0						
19 . Jan 6	To Bill due 7th Jan, 19		303	10	1	19 Jan 7	By Bill due by Smith dishonoured		303	10	1
7	,, First and Final Dividend, Smith		75	18	9		,, Noting Charges thereon .			5	0

Dr. **Discounting Charges** *Cr.*

Date			£	s	d	Date			£	s	d
19 July 1	To Bank .		2	0	0						
	,, ,, .		2	0	0						

Dr. **INTEREST** *Cr.*

			£	s.	d.				£	s.	d.
						19.. Nov. 4	By Smith . .		3	0	1

Dr. **BAD DEBTS** *Cr.*

			£	s.	d.				£	s.	d.
19.. ?	To Smith . .		227	16	4						

Where a bill is dishonoured, the bank will incur charges attendant upon the formalities required by the law, called noting charges, and as the bank has incurred the expense on behalf of its customer it will debit him with the sum so spent. The customer will then credit bank and debit the acceptor to whose fault are attributable the charges for noting.

It may be stated, then, that the effect of dishonour is that the account of the debtor will be readjusted to the position at which it stood *before* the acceptance was given, together with noting charges necessarily incurred by the drawer through his bank. New arrangements will now be required to discharge the debt and not infrequently the new arrangement will involve a payment of interest by the defaulting acceptor.

The position arising when the drawer transfers the bill to his creditor is similar as between themselves. The transferee has relied upon the acceptance passed on to him and naturally he looks to his transferor (not the acceptor) to reimburse him—just as if the transferor had himself accepted the bill instead of passing on another's acceptance. The drawer will consequently debit the acceptor (as before), credit transferee (his creditor).

So far as the acceptor is concerned, he will in the circumstances now discussed, simply debit expenses and credit his drawer's account irrespective of whether the bill had been retained till maturity, discounted or transferred.

The entries for noting charges thus may be summarized—

(1) *In Acceptor's books*—

Debit Expenses, Credit Drawer.

(2) *In Drawer's books*—

Debit Acceptor, Credit Bank or (if the Bill had been transferred) Transferee.

(3) *In Transferee's books*—

Debit Transferor, Credit Bank.

Illustration. If, reverting to the previous illustration (page 151) C had incurred noting charges 10s. on the dishonour of A's acceptance, the entries would be—

(1) In A's books.

Debit Expenses, Credit B.

(2) In B's books.
Debit A (the acceptor), Credit C.
(3) In C's books.
Debit B (the transferor), Credit Bank.

From the outline given in the preceding pages, it will be perceived that even if the bill is discounted there is no certainty that it will be paid at maturity and hence the amount appearing in the bank, assuming that the bill has been discounted, is always subject to a possible reduction at any time in respect of unmatured bills, and this makes it necessary to have full records of such bills in order to know what risk is involved. This risk is an example of what is known as a Contingent Liability.

Retiring a Bill. If all parties agree, a bill may be withdrawn before maturity either because the acceptor desires its withdrawal to avoid its dishonour or because he is desirous of paying the amount without waiting till its due date. The entries are similar to those outlined where a bill is dishonoured substituting the words Bill Retired for Bill Dishonoured; except that no noting charges will be incurred. Interest may, as in the case of dishonour, be charged to the original acceptor where the latter accepts in place of the one retired an entirely new bill.

Illustration. On 1st January, 19.., A accepts a three months' Bill for £1,000 for balance owing to B. On 28th March, 19.., A finds that he will be unable to meet the bill and accordingly B agrees to A retiring the bill and new arrangements are subsequently agreed upon.

Entries in A's books are (ignoring narratives)—

A's Journal

19..				£	£
Jan. 1	B . . . . *Dr.*			1,000	
	To Bills Payable				1,000
Mar. 28	Bills Payable . . . . . *Dr.*			1,000	
	To B				1,000

Entries in B's books are—

B's Journal

19..				£	£
Jan. 1	Bills Receivable . . . . . *Dr.*			1,000	
	To A				1,000
Mar. 28	A . . . . *Dr.*			1,000	
	To Bills Receivable				1,000
	Or (if the Bill had been discounted in the meantime)—				
	Bank				
	Or (if the Bill had been transferred in the meantime to C)—				
	C				

A's LEDGER

Dr. B **Cr.**

19..			£	19..			£
Jan. 1	To Bill Payable due 4th April, 19..		1,000	?	By Balance	b/d	1,000
				Mar. 28	" Bill due 4th April, 19.., retired		1,000

Dr. BILLS PAYABLE **Cr.**

19..			£	19..			
Mar. 28	To Bill due 4th April, 19.., retired		1,000	Jan. 1	By B: Bill due 4th April, 19..		1,000

If B had discounted the Bill on 1st January, 19.. (discounting charges £8) his Ledger would show—

B's LEDGER

Dr. A **Cr.**

19..			£	19..			£
?	To Balance	b/d	1,000	Jan. 1	By Bill due 4th April, 19..		1,000
Mar. 28	" Bill due 4th April, 19.., retired: Bank		1,000				

Dr. BILLS RECEIVABLE **Cr.**

19..			£	19..			£
Jan. 1	To Bill due on 4th April, 19.., accepted by A		1,000	Jan. 1	By Bank		1,000

Dr. BANK **Cr.**

19..			£	19..			£
Jan. 1	To Bill Receivable		1,000	Jan. 1	By Discounting Charges		8
				Mar. 28	" Bill due 4th April, retired		1,000

Dr. DISCOUNTING CHARGES **Cr.**

19..			£				
Jan. 1	To Bank		8				

The position is that, unless the bill is paid at maturity, the parties are back to the point where they started just as if no bill had originally been given; and even if the bill has been discounted the party discounting has obtained, in consideration of the charge made by the bank, the use of the proceeds in the meantime.

The entries subsequent to those made by reason of dishonour or retirement depend upon the nature of the new arrangements. In all probability the defaulting acceptor will be charged with interest and required to pay a proportion of the debt in cash, whilst the acceptor who desires to retire his Bill will usually be called upon to pay the whole of the Bill in cash to the holder as a condition precedent to its withdrawal.

The entry for Interest will be—

In the defaulting Acceptor's books—

(*a*) Debit Interest, Credit Drawer.

In the Drawer's books—

(*b*) Debit Acceptor, Credit Interest.

That is, using the parties previously named—

(*a*) Debit Interest, Credit B.

(*b*) Debit A, Credit Interest.

Should the bill have been transferred to C—

C will debit B and credit Interest, and B will debit Interest and credit C, at the same time debiting A and crediting Interest.

If the bill is retired because the acceptor wishes to pay the bill before maturity the entries will be similar to those arising in the case of payment on the due date (except as regards any rebate given by the Bank to the creditor, in the event of his having discounted the bill).[1]

Illustration. A discounted a bill on 1st January, 19.., being a six months' bill for £1,000 accepted on the date of discount. The bill was retired on 1st May, 19... If the bank makes an allowance of 1 per cent it will be calculated on £1,000 for the period between 1st May, 19.. and 1st July, 19... The computation then is—

$$1{,}000 \times \frac{1}{100} \times \frac{2}{12} = £1\ 13s\ 4d$$

The entry in the bank's book will be—

Debit Discount on Bills.
Credit Customer (A).

The entry in A's book will be—

Debit Bank, Credit Discounting Charges.

The other entries relative to the transaction above are not shown here, having already been fully explained.

Illustration. On 1st December, D sold goods to the value of £1,000 to A.B and £1,000 to M. D draws on each of them at three months for £1,015 (i.e. plus interest at 6 per cent per annum) and received the bills duly accepted on the 6th December. (The acceptances were dated 1st December.)

The goods sold to A.B and M had been purchased from X.Y for £1,600 and by arrangement with them D handed to X.Y on 31st December (when payment for the goods was due) A.B's bill for the credit of his account, which it was agreed should be debited with £7 representing interest from 31st December, to the date of the maturity of the bill, the balance of the account being paid in cash on the same day.

[1] NOTE. When a bill is retired, some banks make no allowance for the period between date of retirement and maturity; others allow interest at a reduced rate on the face value of the bill for such period.

D, on the same date, asked his bank to discount the bill accepted by M. The bank declined, but offered as an alternative a loan at 5 per cent per annum to the full extent of the bill until it matured; the bill was to be endorsed and handed to the bank for collection. This transaction was carried out on 31st December.

Show the Ledger of D up to the 31st December, ignoring the question of bill stamps, expenses, other than arising and given above, and days of grace.

Dr. A.B *Cr.*

19..		£	19..		£
Dec. 1	To Goods[1] . . .	1,000	Dec. 6	By Bill Receivable due 4th March, 19.. .	1,015
6	,, Interest at 6% per annum for 3 mos. on £1,000 . .	15			
		£1,015			£1,015

Dr. M *Cr.*

19..		£	19..		£
Dec. 1	To Goods[1] . . .	1,000	Dec. 6	By Bill Receivable due 4th March, 19.. .	1,015
6	,, Interest at 6% per annum for 3 mos. on £1,000 . .	15			
		£1,015			£1,015

Dr. BILLS RECEIVABLE *Cr.*

19..		£	19..		£
Dec. 6	To A.B; 3 mos. Bill .	1,015	Dec. 31	By Bill due 4th March, 19.., by A.B transferred to X.Y . .	1,015
	,, M; 3 mos. Bill .	1,015			

Dr. X.Y *Cr.*

19..		£	19..		£
Dec. 31	To Bill Receivable due 4th March, 19.., by A.B . .	1,015	?	By Goods[1] . . .	1,600
	,, Cash . . .	592	Dec. 31	,, Interest on Bill .	7
		£1,607			£1,607

Dr. CASH *Cr.*

19..		£	19..		£
Dec. 31	To Bank Loan at 5% per annum on Bill due on 4th March, 19.., by M . . .	1,015	Dec. 31	By X.Y . . .	592

[1] The items marked thus would be entered in and posted from the Day Books in the usual way

Dr.			Bank Loan				*Cr.*
				19. Dec. 31	By Cash: Loan at 5% per annum on Bill due 4th March, 19.., by M		£ 1,015

Dr.			Interest				*Cr.*
19.. Dec. 31	To X.Y . . .		£ 7	19 . Dec. 6	By A.B . . . " M . . .		£ 15 15

The above balances, except interest, would appear in the Balance Sheet at 31st December; the interest being transferred to the credit of Profit and Loss Account.

Ignoring all other entries and thus confining the position to the transactions enumerated, the summary of the result would be—

	Dr.	*Cr.*
	£	£
Profit on Sales, £2,000 – £1,600		400
Interest, £30 – £7		23
Cash	423	
Bill Receivable	1,015	
Bank Loan		1,015

The profit would not appear as a distinct and separate figure because the purchases and sales would form part of the total purchases and sales as written up in and posted from the Day Book.

As the bank is making a *Loan* the interest will be charged up at the date of the maturity of the bill, i.e. 4th March, on £1,015 at 5 per cent per annum for *two* months. This amounts to £8 9s. 2d.

If the bill had been *discounted* the Discounting Charge would be made immediately on discount.[1]

Accommodation Bills. An Accommodation Bill is a bill of exchange which has been accepted, drawn, or endorsed by a person not in the course of ordinary business transactions, but for the specific object of enabling another person to raise funds by discounting the bill on the strength of the first person's name. There is no value given to the accommodating party and hence there is no

[1] If true interest were charged, this would be $\frac{\frac{5}{6}}{100\frac{5}{6}} \times$ £1,015, amounting to £8 7s. 9d., which is interest on the net advance of £1,006 12s. 3d. at 5 per cent per annum. The difference between the two charges of 1s. 5d. is calculated as follows (see pages 148 and 149)—

$$\frac{\frac{5}{6}}{100\frac{5}{6}} \times £8\ 9s.\ 2d. = 1s.\ 5d.$$

liability on his part unless the bill is sued upon by a third party who has either himself given value for the bill or has derived his title thereto from a person who has given value; but when the bill is discounted the banker gives value therefor, and as a consequence, is entitled to hold the accommodating person liable on his acceptance, drawing, or endorsement.

Sect. 28 of the Bills of Exchange Act, 1882, provides—

(1) An accommodation party to a bill is a person who has signed a bill as drawer, acceptor or endorser, without receiving value therefor, and for the purpose of lending his name to some other person.

(2) An accommodation party is liable on the bill to a *holder for value*, and it is *immaterial* whether, when such holder took the bill, he knew such party to be an accommodation party or not.

The book-keeping entries follow the same rules as laid down in this chapter, but it must be remembered that the person who is "accommodated" will reimburse the accommodating party for what is in effect a loan.

Illustration. A accepts a bill for the accommodation of B (say, £100), the latter discounting the bill. The entries in A's books are—

A's Journal

			£	£
	On acceptance—			
	B . . . . . . Dr.		100	
	To Bills Payable			100
	When the bill matures and is paid—			
	Bills Payable . . . . . Dr		100	
	To Bank			100
	When B recoups A—			
	Cash or Bank . . . . . Dr.		100	
	To B			100

The entries in B's books are—

B's Journal

			£	£
	On receipt of acceptance—			
	Bills Receivable . . . . Dr.		100	
	To A			100
	On discounting the bill—			
	Bank . . . . . . Dr.		100	
	To Bills Receivable . . .			100
	Discounting Charges (say) . Dr.		1	
	To Bank			1
	When B recoups A—			
	A . . . . Dr.		100	
	To Bank			100

Where the accommodating party insists upon a bill being accepted in return for his accommodation bill, there will be in each set of books, (1) a series of entries for a Bill Receivable and (2) a series of entries for a Bill Payable. This type of problem causes trouble to students but confusion is easily avoided by keeping the two parts quite distinct and completely dealing with one bill before commencing upon the other.

Illustration. A accepts a bill for the accommodation of B, in return for which B accepts a bill in favour of A—both bills being for three months and for £1,000. A's bill only is discounted, the cost of which is to be borne solely by B. Show the Journal entries in the books of A and B, ignoring narratives.

A's Journal

				£	£
	Bills Receivable	*Dr.*		1,000	
	To B				1,000
	B	*Dr.*		1,000	
	To Bills Payable . . .				1,000
	Bills Payable	*Dr.*		1,000	
	To Bank				1,000
	Bank	*Dr*		1,000	
	To Bills Receivable. . . .				1,000

B's Journal

				£	£
	A	*Dr.*		1,000	
	To Bills Payable				1,000
	Bills Receivable	*Dr.*		1,000	
	To A				1,000
	Bank	*Dr.*		1,000	
	To Bills Receivable. . . .				1,000
	Discounting Charges (say) . .	*Dr*		5	
	To Bank				5
	Bills Payable	*Dr.*		1,000	
	To Bank				1,000

It may happen that the accommodating party DRAWS a bill upon the party to be assisted, instead of ACCEPTING a bill; in this case it will be obviously necessary for the drawer to REMIT cash to enable the acceptor to meet the bill at maturity.

Illustration. In order to accommodate B, A agrees to DRAW on B for £1,000 (the bank being willing to discount for A owing to his high standing—his name being on the bill as Drawer). A discounts the bill for £997 net and remits the proceeds to B. In order that B shall be in a position to meet his acceptance, A remits a cheque for £1,000.

Show abbreviated Journal entries.

A's Journal

		£	£
Bills Receivable . . . . *Dr.*		1,000	
To B			1,000
Bank . . . . . . *Dr.*		1,000	
To Bills Receivable.			1,000
B (Discounting Charge) [1] . . *Dr.*		3	
To Bank			3
B (Remittance) . . . . *Dr.*		997	
To Bank			997
When the bill matures—			
B . . . . *Dr.*		1,000	
To Bank			1,000

B's Journal

		£	£
A . . . . *Dr.*		1,000	
To Bills Payable			1,000
Bank . . . . . . *Dr.*		997	
Discounting Charges . . . *Dr.*		3	
To A			1,000
When the bill due by B matures, he will receive a cheque from A—			
Bank . . . . *Dr.*		1,000	
To A			1,000
He is then able to meet his acceptance thus—			
Bills Payable . . . . . *Dr.*		1,000	
To Bank			1,000

The Ledger Accounts (abbreviated) will be—
A's Ledger (items numbered in order of sequence).

Dr. Bills Receivable *Cr.*

			£			£
	To B (1) . . .		1,000	By Bank (2) . .		1,000

Dr. B *Cr.*

			£			£
	To Charges (3) . . „ Remittance (4) .		3 997	By Bills Receivable (1) . . .		1,000

[1] The charge of £3 being for B's benefit should be debited to B.

Dr. BANK *Cr.*

			£				£
	To Bills Receivable (2)		1,000		By Charges (3) . .		3
					,, B (4) . . .		997

It will be observed that the foregoing entries cancel out, leaving the last entry when A forwards his cheque to B, which to avoid confusing the student will be shown below, but actually would be entered in the above accounts.

Dr. B *Cr.*

			£				
	To Cheque (5) . .		1,000				

Dr. BANK *Cr.*

							£
					By B (5) . .		1,000

At the end of all these transactions B owes A £1,000.

B's Ledger (items numbered in order of sequence).

Dr. BILLS PAYABLE *Cr.*

			£				£
	To Bank (5) . .		1,000		By A (1) . . .		1,000

Dr. A *Cr.*

			£				£
					By Remittance (2) .		997
	To Bills Payable (1) .		1,000		,, Charges (3) . .		3
					,, Cheque (4) . .		1,000

Dr. BANK *Cr.*

			£				£
	To A (2) . . .		997				
	,, A (4) . . .		1,000		By Bills Payable (5 .		1,000

Dr. DISCOUNTING CHARGES *Cr.*

			£				
	To A (3) . . .		3				

A is thus a creditor for £1,000, which is represented by cash in the bank, £997, and discounting charges, £3.

Sometimes a bill is drawn up for mutual accommodation whereby the proceeds after discounting are divided between the parties equally, the discounting charges being similarly apportioned. This may be effected by the entries already outlined, e.g. in the

preceding illustration A would have remitted to B £997 × ½ only, = £498 10s. and debited B with discounting charges £1 10s., the other £1 10s. remaining charged against himself.

Illustration. X accepts a bill drawn by Y for their mutual accommodation on an equality basis; the bill is for £500, discounting charges £6. Upon maturity Y reimburses X for his proportionate part of the liability.

Entries in X's books—

X's Journal

			£	£
	On acceptance—			
	Y . . . . *Dr.*		500	
	To Bills Payable			500
	On receiving half net proceeds of discounting from Y—			
	Bank . . . . . . *Dr.*		247	
	Discounting Charges . . . *Dr.*		3	
	To Y			250
	On payment of bill at maturity—			
	Bills Payable . . . . . *Dr.*		500	
	To Bank			500
	On receipt of Y's reimbursing remittance—			
	Bank . . . . . . *Dr.*		250	
	To Y			250

Entries in X's Ledger (abbreviated)—

Dr. Bills Payable *Cr.*

			£				£
	To Bank (4) . .		500		By Y (1) . . .		500

Dr. Y *Cr.*

			£				£
	To Bills Payable (1) .		500		By Remittance (2) .		247
					,, Charges (3) . .		3
					,, Cheque (5)[1] . .		250

Dr. Bank *Cr.*

			£				£
	To Y (2) . . .		247		By Bills Payable (4) .		500
	,, Y[1] (5) . . .		250				

[1] Should Y fail to pay this, the above entry would not be made; and if the amount was irrecoverable from Y, a transfer would be made as follows—

Debit Bad Debts Account, Credit Y.

Y being one of the parties to the accommodation bill in *law* is not liable thereon, except to a holder for value.

Dr. **Discounting Charges** Cr.

		£		
To Y (3)	. . .	3		

Thus at the conclusion of the transactions, Y's bank balance is reduced by £3 reflected in discounting charges, representing the cost of accommodation on £250.

Entries in Y's books—

Y's Journal

		£	£
On receipt of X's acceptance—			
Bills Receivable . . .	Dr.	500	
To X			500
On discounting the bill—			
Bank	Dr.	500	
To Bills Receivable . . .			500
X	Dr.	3	
Discounting Charges. . .	Dr.	3	
To Bank			6
On payment to X of half proceeds—			
X	Dr.	247	
To Bank			247
On discharge of his liability to X—			
X	Dr.	250	
To Bank			250

The entries in Y's Ledger (abbreviated)—

Dr. **Bills Receivable** Cr.

	£		£
To X (1) . . .	500	By Bank (2) . .	500

Dr. **X** Cr.

	£		£
To Charges (3) . .	3	By Bills Receivable (1)	500
,, Cheque (5) . .	247		
,, ,, (6) . .	250		

Dr. **Bank** Cr.

	£		£
To Bills Receivable (2)	500	By X (3) . . .	3
		,, Charges (4) . .	3
		,, X (5) . . .	247
		,, X (6) . . .	250

Dr. **Discounting Charges** Cr.

	To Bank (4) . .		£ 3				

On conclusion, Y's position is precisely the same as X's, that is, his bank balance is reduced by £3 reflected in discounting charges of £3, representing the cost of accommodation on £250.

If X fails to meet the bill of £500, entry (6) will not appear and his account will be debited with £500 (or, as the case may be, Bad Debts Account) and the bank credited. This will result in X's account (unless written off) being in debit for £250, thus—

Dr. **X** Cr.

	To Charges . .		£ 3		By Bills Receivable .		£ 500
	,, Cheque . . .		247				
	,, Bill dishonoured .		500				

Illustration. On 1st January, 1952, A drew, and B accepted, a bill at three months for £1,000. On 4th January A discounted the bill at 6 per cent per annum and remitted half the proceeds to B. On 1st February, 1952, B drew and A accepted a bill at three months for £400. On 4th February B discounted the bill at 6 per cent per annum and remitted half the proceeds to A. A and B agreed to share the discounts equally.

At maturity A met his acceptance, but B failed to meet his, and recourse was had to A; A drew and B accepted a new bill at three months for the amount of the original bill plus interest at 5 per cent per annum.

On 1st July, 1952, B became bankrupt. A first and final dividend of 10s. in the £ was paid by his Trustee in Bankruptcy on 31st October, 1952. B obtained his discharge on 5th December, 1952, and agreed to pay A the unsatisfied balance of his account; this was paid on 10th November, 1953.

Write up B's account in A's books and state how you would advise A to treat the balance on the account when preparing his Balance Sheet as on 31st December, 1952. Make calculations in months and compute discount on face value of bill. The answer appears on page 168.

Bill Books. Where the dealings in bills are frequent, separate books are employed to show complete details both of bills receivable and of bills payable.

The general form of the usual bill books is shown on page 169

The form will be adapted to the particular requirements of the business.

The bill when received will be entered in the relevant book, the sender of the bill being usually, but not necessarily, the acceptor; drawer of a bill may endorse it over to his creditor so that it is necessary to have columns to note *all* parties according to their

In the Books of A—

Dr.					B				*Cr.*
1952		£	s	d	1952		£	s	d.
Jan. 4	To Cash: Half Proceeds of Bill discounted	492	10	0	Jan 1	By Bill Receivable due 4th April	1,000	0	0
	" Half Share of Discounting Charges on above . .	7	10	0	Feb 4	" Cash Half Proceeds of Bill discounted .	197	0	0
Feb. 1	" Bill Payable due 4th May, 1952	400	0	0		" Half Share of Discounting Charges on above . .	3	0	0
April 4	" Bank: Bill Dishonoured .	1,000	0	0	April 4	" Bill Receivable due 7th July	1,012	10	0
	" Interest thereon at 5% per annum for 3 months .	12	10	0	Oct. 31	" First and Final Dividend of 10s in £ paid by Trustee in Bankruptcy of B . .	356	5	0
July 7	" Bill Dishonoured .	1,012	10	0	Dec. 31	" Bad Debts[2]	356	5	0
		£2,925	0	0			£2,925	0	0
1953 Nov. 10	To Bad Debts[1]	356	5	0	1953 Nov 10	By Cash . .	356	5	0

relation to the bill. When the bill is disposed of, by endorsement to a creditor, or by discount, or by presentment for payment at maturity, suitable entries will be made

The book may be used by way of memorandum only or as part of the double entry; in the latter case, the amounts of the bills will be posted to the CREDIT of the SENDER, not necessarily the ACCEPTOR, and the total of the "amounts" column posted to the DEBIT of Bills Receivable. If desired, further columns may be employed for discounts allowed, and, on the disposal side, a discounting charges column, but as to whether these extra columns are justified depends to a great extent upon the uniformity or otherwise of the treatment of bills, e.g. *all* the bills as received may be sent for discounting.

[1] At 31st October, 1952, when it is clear that nothing more will be received (a first *and final* dividend having been declared), A would write off the remainder of the debt to Bad Debts Account He might postpone making this entry until preparing his accounts at the end of December and in the meantime receive B's agreement to pay the unsatisfied balance. Nevertheless, at 31st December the amount should be written off to Bad Debts Account or a provision should be created therefor, as B's agreement to pay is unenforceable, unless valuable consideration has been given or a deed executed by A, since the old debt has been extinguished in the bankruptcy. No reversing entry should be made until the amount is actually received.

[2] B's balance is £356 5s. 0d made up as follows—

	£	s.	d.
(1) $\frac{1}{2} \times$ £1,000	500	0	0
(2) $\frac{1}{2} \times$ £400	200	0	0
(3) Interest	12	10	0
	712	10	0
Less Dividend . .	356	5	0
	£356	5	0

Bills Payable Book

No. of Bill	Date Given	To whom sent	Drawer	Payee	Where Payable	Date of Bill	Tenor	Due Date including days of grace	Folio	Amount			Remarks
										£	s.	d.	

Bills Receivable Book

No. of Bill	Date Received	From whom received	Drawer	Acceptor	Endorser(s)	Where Payable	Date of Bill	Tenor	Due Date including days of grace	Folio	Amount			Date of Disposal	To Whom Sent	Discounting Charges	Remarks
											£	s.	d.				

Columns for Discount and Interest may be added, if necessary.

Bills Discounted Register

No. of Bill	Date	Name	Drawer	Payee	Acceptor	Date of Bill	Tenor	Due Date	Amount			Days to Run	Discount	Remarks
									£	s.	d.			

The remarks column is employed for insertion of necessary observations. It is customary to pass dishonoured bills through the Journal.

If the Bill Book is employed by way of memorandum only, the entries for bills will flow through the usual channel, viz. the Journal.

The following example will explain the principle of double-entry as applied to the Bills Receivable Book. (The "record" columns will be eliminated.)

Illustration.

BILLS RECEIVABLE BOOK

From whom Received	Cash Discount Allowed	Bills Received (1)	Bills Paid into Bank (2)	Discounting Charges
	£	£	£	£
A	3	50	50	2
B	2	20	20	1
D	4	106	106	4
A	2	38	38	2
R	5	95		
			214	9
			Bal. 95	
	£16	£309	£309	£9

The bill and discount items will be posted to the credit of the individual customers and the total discounts (£16) and bills (£309) will be posted to the debit of Discounts and Bills Receivable Accounts respectively. The payments to Bank will be posted separately to the debit of Bank and credited to Bills Receivable Account; the discounting charges will be credited separately to the Bank and the total thereof posted to the debit of Discounting Charges. The balance of columns 1 and 2 will be carried forward as bills on hand.

The Bills Payable Book will be ruled and employed similarly (except that no entries for discounting charges will be necessary). The headings are as given on p. 169.

When bill transactions are numerous a special Bill Diary should be kept so that the amounts receivable and payable on any day can be readily ascertained.

Bills for Collection. A banker, in addition to discounting bills, collects proceeds or makes an advance to the customer representing a proportion of the face value of the bill. In these circumstances the Bank will be debited only when they have collected, in the meantime a special account called Collection Account being opened. Bills paid into a Bank for collection are sometimes termed "Short Bills," since they have only a short time to run.

Sometimes a banker retains a proportion of the proceeds of a bill as security for advances made against other bills This proportion.

is credited to the customer's Special Margins Account and a Marginal Deposit Receipt is issued. When all the bills have been met, the balance on the Special Margins Account is paid to the customer.

Illustration. A has £10,000 of bills. The Banker agrees to receive £4,000 for collection, and upon the remainder he is prepared to make an advance of 25 per cent. Assuming all the "Collection" bills are met, except one for £200, and all the "Advance" bills are likewise met except one for £1,000, show entries in A's books. Banker's Expenses on Collections are £40, and on Advances £50. Interest, £48.

Dr. BILLS RECEIVABLE *Cr.*

			£				£
	To (details) .		10,000		By Bills for Collection Account . .		4,000
					,, Bills for Collection (Advance) Account		6,000
			£10,000				£10,000

Dr. BILLS FOR COLLECTION *Cr.*

			£				£
	To Bills Receivable .		4,000		By Cash . . .		3,760
					,, Collection Expenses .		40
					,, Bills Uncollected		200
			£4,000				£4,000

Dr. BILLS FOR COLLECTION (ADVANCE) *Cr.*

			£				£
	To Bills Receivable .		6,000		By Advance Account .		4,950
					,, Collection Expenses .		50
					,, Bills Uncollected		1,000
			£6,000				£6,000

Dr. ADVANCE ON BILLS FOR COLLECTION *Cr.*

			£				£
	To Bills for Collection (Advance)		4,950		By Cash . . .		1,500
					,, Interest . . .		48
					,, Cash, Balance of Bills Collected *less* Expenses . .		3,402
			£4,950				£4,950

Dr BANK *Cr.*

			£				
	To Advance on Bills		1,500				
	,, Bills for Collection		3,760				
	,, Advance on Bills		3,402				

Dr.	Collection Expenses					*Cr.*
			£			
	To Bills for Collection .		40			
	,, Bills for Collection (Advance) .		50			

Dr.	Interest					*Cr.*
			£			
	To Advance on Bills		48			

Dr.	Bills Uncollected					*Cr.*
			£			
	To Bills for Collection[1]		200			
	,, Bills for Collection (Advance) .		1,000			

The Bank or Discounting House. Upon the discounting of a bill for a customer the Discounting House will effect the following entries in its books—

(1) Debit Bills Discounted Account.
(2) Credit Customer's Account with "proceeds."
(3) Credit Discount on Bills Account with discounting charges.

On maturity (if bill met)—
Debit Cash, credit Bills Discounted Account.

On maturity (if bill dishonoured)—
Debit customer, credit Bills Discounted Account.

Illustration. On 30th November, 1952, A discounts a bill of exchange for B. The bill matures on the following 4th March, interest is at 5 per cent per annum, and the amount of the bill is £1,000. Calculate interest in months. Show the Journal entries in A's books (ignoring narratives).

A's Journal

			£	s.	d.	£	s.	d.
1952 Nov. 30	Bills Discounted . . *Dr.*		1,000	0	0			
	To B					987	10	0
	,, Discount on Bills . .					12	10	0

If A is a banker he will make two distinct entries—

(*a*) Credit the gross amount of the bill to the customer.
(*b*) Debit the discounting charge to the customer.

A's Journal

			£	s.	d.	£	s.	d.
1952 Nov. 30	Bills Discounted . . *Dr.*		1,000	0	0			
	To B					1,000	0	0
	B . . . . *Dr.*		12	10	0			
	To Discount on Bills . .					12	10	0

[1] This account would be dealt with according to the reasons for non-collection, but normally a transfer would be made to the debit of the drawee (as these transactions chiefly arise in connection with exports, the foreign importer not accepting until receipt of the goods at the destination).

In practice, the entries will not be journalized but passed through special subsidiary books. See ruling on page 169.

The total of Discount on Bills Account will, at the end of the customary accounting period, be transferred to the credit of Profit and Loss Account.

Rebate on Bills Discounted. Although on discounting a bill, the Discounting House debits the customer with the amount of the charge and credits, as a profit, the Discount on Bills Account, it would manifestly be imprudent to consider it as *earned* until the Bill had been finally cleared by a payment. At the end of the accounting period the correctly proportionate part of the total credits of Discount on Bills Account is taken as profit; in other words, the amount is divided in the same ratio as the EXPIRED portion of the period for which the Bill is under discount bears to the UNEXPIRED, the latter portion being carried forward as a "liability." This may be done by a transfer to a separate account bearing the imposing title of Rebate on Bills Discounted Account, or by the familiar entry, made in the Discount on Bills Account, debit above the "line," credit below the "line."

Illustration. Continuing the illustration on page 172, the Ledger Accounts of A, whose year runs to 31st December, would now be—

Dr. DISCOUNT ON BILLS *Cr.*

			£	s.	d.				£	s.	d.
1952 Dec. 31	To Transfer to Rebate on Bills Discounted Account[1] .		8	6	8	1952 Nov. 30	By B		12	10	0
	„ Profit and Loss Account .		4	3	4						
			£12	10	0				£12	10	0
						1953 Jan. 1	By Transfer from Rebate on Bills Discounted Account .		8	6	8

Dr. REBATE ON BILLS DISCOUNTED *Cr.*

			£	s.	d.				£	s.	d.
1953 Jan. 1	To Transfer to Discount on Bills Account . .		8	6	8	1952 Dec. 31	By Discount on Bills Unearned[1] . .		8	6	8

Alternatively—

Dr. DISCOUNT ON BILLS *Cr.*

			£	s.	d.				£	s.	d.
1952 Dec. 31	To Discount Unearned . .	c/d	8	6	8	1952 Nov. 30	By B		12	10	0
	„ Profit and Loss Account . .		4	3	4						
			£12	10	0				£12	10	0
						1953 Jan. 1	By Discount Unearned	b/d	8	6	8

[1] I.e. two-thirds of £12 10s., being the proportion unexpired (two months) over the total period (three months) of £12 10s. This item would appear in A's Balance Sheet at 31st December, 1952, as a liability.

The latter method avoids the necessity for opening a separate account.

Actually there will not be a separate *Discount on Bills Account for each transaction*, any more than in ordinary trading there will be separate sales accounts for each sale; the "carry forward" figure being constructed from the schedule of bills outstanding.

The same process will be carried out each year, so that the amount carried forward will benefit the succeeding year, e.g. in the example just given, if there were no alteration to the facts, the amount of £8 6s. 8d. would be transferred to the credit of Profit and Loss Account for the year ended 31st December, 1953.

The following example is given, showing a collective Discount on Bills Account.

Illustration. A bank has the following accounts in its books relative to bills discounted at 31st December, 1952—

	£
Unearned Discount, 1st January, 1952	420
Discount on Bills—year to 31st December, 1952 . .	6,200
Allowances thereon to customers during the year to 31st December, 1952	150

Unearned discount is to be calculated and the Discount on Bills Account closed off for the year ended 31st December, 1952.

There were the following discounting charges credited but not fully earned (*days of grace ignored*).

	Date of Acceptance	Term in Months	Date of Maturity	Date of Discounting
1. Sundry Bills (estimated carry forward, £220 5s.)				
2. Bill for £500 at 5% p.a.	1 Aug., 1952	6	1 Feb., 1953	1 Aug., 1952
3. Bill for £2,000 at 5% p.a.	1 Nov., 1952	4	1 Mar., 1953	1 Dec., 1952
4. Bill for £1,200 at 6% p.a.	1 Nov., 1952	5	1 April, 1953	15 Dec., 1952
5. Bill for £600 at 5% p.a.	1 Dec., 1952	3	1 Mar., 1953	31 Dec., 1952
			*	*

The proportion of profit on discounting to be carried forward is calculated as follows—

Bill No.	Period of Discounting	Months	Months prior to 31st Dec., 1952	Months subsequent to 31st Dec., 1952	Proportion to carry forward
2	1 Aug., 1952, to 1 Feb., 1953 . .	6	5	1	1 : 5 (or 1/6)
3	1 Dec., 1952, to 1 Mar., 1953 . .	3	1	2	2 : 1 (or 2/3)
4	15 Dec., 1952, to 1 April, 1953 . .	3½	½	3	3 : ½ (or 6/7)
5	31 Dec., 1952, to 1 Mar., 1953 . .	2	0	2	Total

In the above, columns marked * are the important ones.

The amount to be carried forward is £262 as shown below—

Bill No.	Details	Total Discount	Proportion to carry forward	Amount to carry forward
		£ s. d.	£ s. d.	£ s. d.
2	£500 at 5% p.a. for 6 months =	12 10 0	$\frac{1}{6}$ × 12 10 0	2 1 8
3	£2,000 at 5% p.a. for 3 months =	25 0 0	$\frac{2}{3}$ × 25 0 0	16 13 4
4	£1,200 at 6% p.a. for $3\frac{1}{2}$ months =	21 0 0	6/7 × 21 0 0	18 0 0
5	£600 at 5% p.a. for 2 months =	5 0 0	$\frac{2}{2}$ × 5 0 0	5 0 0
				41 15 0
	Plus Sundries (No. 1)	. .	. . .	220 5 0
	Total of carry forward	. .	. . .	£262 0 0

It is of VITAL importance to see that the calculations are made by reference to the discounting period, viz. the period from the date of *discounting* to the date of *maturity*, so that the date of acceptance merely serves as a guide to the date of maturity and does not otherwise enter into the above calculations.

For instance, taking No. 3 Bill, it will be seen that the bank becomes interested on 1st December, 1952, and as the bill is a four months' bill it matures on 1st March, 1953; hence the bank in effect lends money on the security of the bill for the THREE months, 1st December, 1952, to 1st March, 1953, charging interest on £2,000 at 5 per cent for three months, which equals £25, that is £8 6s. 8d. per month. This can be readily calculated by the formula of 5 per cent being "a penny in the £ per month" and 2,000 pence = £8 6s. 8d.

At 31st December, 1952, therefore, one month's interest (£8 6s. 8d.) has been earned but £25 has been credited, hence £16 13s. 4d. must be carried forward, which is shown in the schedule, $\frac{2}{3}$ × £25. All the other calculations may be independently checked, e.g. No. 4 interest is earned for half a month, but interest (6%) for one month is "one shilling per £10 per month," which on £1,200 is 120s. and therefore for half a month, 60s., or £3. The total discount on the bill must be seven times £3, as the discounting period is 15th December, 1952 to 1st April, 1953, viz. $3\frac{1}{2}$ months. Hence the total discount is £21, of which £3 has been earned to 31st December, 1952, involving a carry forward of £18.

Entries in Bank Ledger—

Dr. DISCOUNT ON BILLS *Cr.*

			£				£
1952 Dec. 31	To Allowances . .		150	1952 Jan. 1	By Balance: Discount Unearned . .	b/d	420
	,, Discount Unearned	c/d	262	Dec. 31	,, (details) . .		6,200
	,, Profit and Loss Account . .		6,208				
			£6 620				£6,620
				1953 Jan. 1	By Balance: Discount Unearned[1] . .	b/d	262

[1] Shown as a liability in Balance Sheet.

Bills as Security. Where a bill is deposited as security, there is no sale of the bill as in the case of a bill being transferred or discounted, so that the entries relating to transfers and discounting of bills do not apply. The ownership of the bill is still the borrower's, subject to his discharging his obligation to the lender at the due date.

A note will be required in the books as to the fact that the bill has been deposited as security and such other details as the circumstances require.

Illustration. On 1st March, 19.., A receives a 3 months' bill for £2,000 from B in payment of his account, whereupon he forthwith deposits it with X as security for a loan of £1,500 at 8 per cent per annum. The bill is met at maturity and the lender remits to A the balance of the proceeds of the bill after deducting the total amount of indebtedness. Show the Journal entries in the books of the borrower, ignoring income tax and days of grace.

JOURNAL

19..		£	£
March 1	Bills Receivable . . . . *Dr.*	2,000	
	To B		2,000
	Being 3 months' Bill in payment of account		
	Cash . . . . *Dr*	1,500	
	To X		1,500
	Being Loan at 8% per annum for 3 months on security of B's Bill of £2,000		
June 1	X . . . . . . *Dr*	2,000	
	To Bills Receivable . . .		2,000
	Being Bill collected by X.		
	Cash . . . . *Dr*	470	
	Interest . . . . *Dr*	30	
	To X		500
	Being proceeds of B's Bill collected by X after deducting repayment of Loan of £1,500 at 8% per annum, and Interest thereon for 3 months		

CHAPTER VII

DEPRECIATION, RESERVES, AND PROVISIONS

DEPRECIATION

DEPRECIATION may be defined as the permanent and continuing diminution in the quality, quantity, or value of an asset. The purchase of an asset, generally, is nothing more than a payment in advance for an expense. A simple example of this is seen in the purchase of buildings. By such purchase the purchaser expends a certain sum in advance, as a result whereof he will save the cost of rent in the future, but at the end of a period of years the building will become valueless. Thus the purchase outlay is the equivalent to paying rent in advance for a period of years.

The reason for the non-permanency of an asset is merely that in consequence of natural laws it usually suffers from the effects of TIME. The infinite variety of operative causes superimposed upon the fundamental one—the effluxion or lapse of time—will cause unequal INCIDENCE in the depreciation burden; hence the amounts of depreciation will vary according to circumstances. Obviously the elements of destruction will, sooner or later, overcome the elements of resistance.

The question of depreciation must be differentiated from FLUCTUATION, not only because the latter is temporary, but because it may signify an *increase* in the value of an asset. Speaking generally, the question of fluctuation confines itself to the money value aspect.

The chief agents or causes of depreciation are—

(*a*) Wear and tear.

(*b*) Physical factors: evaporation of liquids, loss of potency of acids, erosion, dampness.

(*c*) Obsolescence, due to invention or change of fashion.

(*d*) Fall in market prices (including foreign exchange rates).

(*e*) Effluxion of time.

All attachable and incidental revenue expenses *must* be provided for before the true profits can be computed, so that whether the particular expense is wages, repairs, or depreciation it follows that a proportion—exact or as approximately so as the circumstances permit—for the use or consumption of an asset must be included in the charge for running the business.

The provision for depreciation does not depend upon what the business "can afford" as the debit therefor is an essential one, constituting not an appropriation of, but a *charge* against, profits for the period in question.

The distinction between *maintenance* and *depreciation* is important. A machine may be kept in a high state of efficiency, e.g. by constant overhauling and prompt replacement of parts, such being always necessary; but the expenditure on upkeep and preservation can never be a substitute for making provision for the time when the machine is merely a bundle of scrap-iron—ready to be sold to the scrap-metal broker. During the usual yearly period a year's life has been "consumed," however careful the activities of the engineer in maintaining the efficiency of machines, so that the cost of such consumption should be charged up against the profits of the appropriate period, however great may be the difficulty of measuring it.

Whatever method is adopted, the following principles are fundamental—

(1) Assets with certain possible exceptions, e.g. land, antiques, etc., suffer depreciation, although the process may be invisible or gradual.

(2) The provision for depreciation (unless excessive) is a *charge* against profits.

(3) Maintenance of assets in a state of efficiency is not a substitute for the depreciation provision.

(4) The building up of a CASH FUND (by deposit in a special Banking Deposit Account, or by insurance policy, or by outside investments) is not a provision for depreciation of an asset but a financial procedure for ensuring its replacement.

(5) The question of the replacement of an asset is incidental to, but not a fundamental question of, depreciation.

The more important methods of dealing with depreciation will now be considered.

(1) **Straight Line Method.** By this method the original cost less the residual value, divided by the number of years of useful life, is the annual revenue charge, the amount thereof being equally divided (repairs being also charged to Revenue). The advantage of this method is its simplicity and the fact that it entirely eliminates the asset where no residual value will ensue by the end of its life, although it is often quoted as a disadvantage that the early years should be charged with the same depreciation as the later, when an asset, e.g. machine, may be losing its efficiency. This, as can clearly be seen, will tend to be levelled out when there are a number of machines bought in different years, as what is undercharged on the one is overcharged on the other. This method has been judicially recommended where, for the purpose of computing an employee's remuneration based on a share of profit, depreciation of fixed assets should be calculated on the straight line method (*Edwards* v. *Saunton Hotels*).

Illustration. Machine cost £1,000. Life 3 years. Residual value £125. Show Machine Account.

Dr.						MACHINE					*Cr.*
			£	s	d.				£	s.	d.
Year 1	To Cash. . .		1,000	0	0	Year 1	By Profit and Loss Account:[1] Depreciation		291	13	4
							,, Balance . .	c/d	708	6	8
			£1,000	0	0				£1,000	0	0
Year 2	To Balance . .	b/d	708	6	8	Year 2	By Profit and Loss Account: Depreciation		291	13	4
							,, Balance . .	c/d	416	13	4
			£708	6	8				£708	6	8
Year 3	To Balance . .	b/d	416	13	4	Year 3	By Profit and Loss Account: Depreciation	c/d	291	13	4
							,, Balance . .		125	0	0
			£416	13	4				£416	13	4
	To Balance . .	b/d	£125	0	0		By Cash .		£125	0	0

(2) **Diminishing Balance Method.** By this method a fixed percentage is written off the diminishing balance of the Asset Account yearly. The chief advantage over (1) is that the charges in relation to the opening and closing years of the Asset Account are more scientifically provided for, the depreciation charge being heavy in the early years when the cost of repairs is light. The student will see that the percentage will have to be much greater than in (1). Theoretically, the asset can never be entirely written off.

Examination candidates often experience difficulty in computing the amount of depreciation to be provided in respect of additions to fixed assets made during the period of the accounts. Where dates of additions are given, it can be assumed that depreciation is to be provided on the additions on a time basis. Thus, if the rate is 5 per cent per annum and additions are made halfway through the year, the effective rate will be 2½ per cent.

Occasionally the rate is given without the words "per annum," in which case the date of the additions is immaterial. Where no dates of additions are given but it is obvious that depreciation should be on a time basis, an average date halfway through the period should be taken. On the other hand, where insufficient information about the additions is given to enable depreciation to be calculated on a time basis, then the computation should be made on the final debit figure standing on the asset account.

[1] Where a Production Account is required, the depreciation of the machinery used in production will be debited thereto, otherwise the transfer is to Trading Account or Profit and Loss Account. The student is advised to charge depreciation to the latter account where no Production Account is required, making a footnote that some accountants debit the charge to Trading *or* Profit and Loss Account

Illustration. Machine cost £1,000. Life 3 years. Residual value £125. Show Machine Account.

Dr. MACHINE *Cr.*

			£				£
Year 1	To Cash . . .		1,000	Year 1	By Profit and Loss Account: Depreciation[1] .		500
					,, Balance . . .	c/d	500
			£1,000				£1,000
Year 2	To Balance . . .	b/d	500	Year 2	By Profit and Loss Account: Depreciation .		250
					,, Balance . . .	c/d	250
			£500				£500
Year 3	To Balance . .	b/d	250	Year 3	By Profit and Loss Account: Depreciation .		125
					,, Balance . . .	c/d	125
			£250				£250
	To Balance . . .	b/d	£125		By Cash . . .		£125

(3) **Annuity Method.** Under this system the capital sunk is assumed to earn a certain rate of interest, the asset being charged accordingly; the amount of depreciation to be written off yearly is calculated on the straight line method so that it eliminates the asset or brings it down to its residual value (if any) after charging it with interest on the value of the asset at the commencement of each year.

The book-keeping entries are—

Debit the asset each year with the interest charge at the rate chosen and credit Profit and Loss Account through Interest Account.[2] This charge will *diminish* each year.

Debit Profit and Loss Account direct or through a Depreciation Account and credit the asset with the depreciation charge. This amount will be the *same* each year.

The figure of depreciation will be obtained from Annuity Tables.

As the yearly interest diminishes whilst the depreciation charge is the same, the net charge to revenue increases annually.

The above procedure is usually confined to the writing off of leases. The following illustration shows the method as applied to a machine, so that comparison may be made with the other methods of depreciation.

Illustration. Machine cost £1,000. Life 3 years. Residual value £125. Interest at 5 per cent per annum. Show Machine Account.

[1] The rate is 50% on diminishing balance.
[2] Deduct from Depreciation in the Profit and Loss Account.

Dr. MACHINE *Cr.*

			£	s.	d.				£	s.	d.
Year 1	To Cash . .		1,000	0	0	Year 1	By Profit and Loss Account: Depreciation		327	11	2
	,, Interest on £1,000 at 5% p.a.		50	0	0		,, Balance . .	c/d	722	8	10
			£1,050	0	0				£1,050	0	0
Year 2	To Balance . .	b/d	722	8	10	Year 2	By Profit and Loss Account: Depreciation		327	11	2
	,, Interest on £722 8s. 10d. at 5% p.a. .		36	2	6		,, Balance . .	c/d	431	0	2
			£758	11	4				£758	11	4
Year 3	To Balance . .	b/d	431	0	2	Year 3	By Profit and Loss Account: Depreciation		327	11	2
	,, Interest on £431 0s. 2d. at 5% p.a. . .		21	11	0		,, Balance . .	c/d	125	0	0
			£452	11	2				£452	11	2
	To Balance . .	b/d	£125	0	0		By Cash . .		£125	0	0

(4) **Sinking Fund Method.** By this method the cash necessary to replace the asset at the end of its effective life is provided. As with the annuity method, the sinking fund method also takes interest into account. An agreed amount is set aside each year and invested, which, with compound interest, will be sufficient to provide a sum equal to the cost of the asset, less residual value (if any). The advantage attaching to the employment of this method is that cash will be forthcoming to provide for the renewal[1], but it must also be remembered that it may be a disadvantage to take out of the business liquid capital which can be more conveniently and advantageously employed in the business. The book value of the asset remains unaltered during the period of the building up of the Sinking Fund, the depreciation being reflected in the credit balance of the Sinking Fund. At the end of such period the Sinking Fund balance will be transferred to the credit of the asset, leaving the balance of the latter at the figure computed for the residual value.

As it will be necessary to advert to the book-keeping entries at a later stage, the entries are shown on page 190 to avoid repetition.

Illustration. Machine cost £1,000. Life 3 years. Residual value £125. Investment at 5 per cent. Show Accounts, assuming that the yearly amount to be set aside is £277 11s. 2d.

[1] Assuming that replacement cost is the same as the original cost.

Dr. SINKING FUND *Cr.*

			£	s.	d.				£	s.	d.
Year 1	To Balance . .	c/d	277	11	2	Year 1	By Profit and Loss Account . .		277	11	2
Year 2	To Balance . .	c/d	568	19	10	Year 2	By Balance . .	b/d	277	11	2
							,, Interest . .		13	17	6
							,, Profit and Loss Account . .		277	11	2
			£568	19	10				£568	19	10
Year 3	To Balance .	c/d	875	0	0	Year 3	By Balance . .	b/d	568	19	10
							,, Interest . .		28	9	0
							,, Profit and Loss Account . .		277	11	2
			£875	0	0				£875	0	0
	To Machine Account		£875	0	0		By Balance . .	b/d	£875	0	0

Dr. MACHINE *Cr.*

			£				£
Year 1	To Cash (Cost) . .		1,000	Year 3	By Sinking Fund Account . .		875
					,, Cash[1] . . .		125
			£1,000				£1,000

Dr. SINKING FUND INVESTMENT—5% STOCK *Cr.*

Year			£	s.	d.	Year			£	s.	d.
1	To Cash		277	11	2	1	By Balance . . .	c/d	277	11	2
2	To Balance . . .	b/d	277	11	2	2	By Balance . . .	c/d	568	19	10
	,, Cash . £13 17 6										
	,, Cash . 277 11 2		291	8	8						
			£568	19	10				£568	19	10
3	To Balance . . .	b/d	568	19	10	3	By Balance . . .	c/d	875	0	0
	,, Cash £28 9 0										
	,, Cash . 277 11 2		306	0	2						
			£875	0	0				£875	0	0
4	To Balance . . .	b/d	875	0	0						

The student will observe that the fund and its counterpart are always equal.

[1] The investments will be sold for £875, which together with £125 cash received for the scrap value of the old machine, will provide £1,000 towards the cost of a new machine.

(5) **Insurance Policy Method.** By this method steps are taken similar to those under the Sinking Fund method except that the investment takes the form of annual payments of premium to an insurance company, whilst no interest on investment is actually received.

Actually the policy does yield "interest" as the policy moneys receivable normally exceed the total premiums, but as the premiums are payable in advance, the calculation of interest will be for a year longer than under the Sinking Fund method.

An endowment policy is taken out to produce the sum required at the end of the life of the asset. An Endowment Policy Account and an Asset Amortization Account will be opened as for the Sinking Fund method. Interest earned on the policy will be debited to the Endowment Policy Account and credited to the Asset Amortization Account.

The interest earned will be the excess of the policy moneys payable over the total premiums. As mentioned, the policy moneys will not be payable until one year *after* the payment of the last premium, so that it will be necessary to pay the first and each subsequent premium at the *commencement* of each year.

Illustration. The same facts as before except that an endowment policy for three years is taken out for £875, the annual premium being £274 16s. 11d., which works out at 3 per cent compound interest. Show Endowment Policy Account and Asset Amortization Account. (These accounts appear on page 184.)

Alternatively, the policy may be revalued yearly at the surrender value[1] either with or without taking into account interest, the "loss" on revaluation being debited to the Sinking Fund or Asset Amortization Account and credited to the Endowment Policy Account. When the policy matures there will be a "profit" as the full value of the policy will be payable, and this will be debited to the Policy Account and credited to the Sinking Fund or Asset Amortization Account.

Illustration. Same facts as in the preceding illustration except that no interest is taken into account, and that the surrender values are—

Year 1 (end) £30. Year 2 (end) £225.

Show Endowment Policy Account and Asset Amortization Account. (These accounts are shown on page 185.)

[1] The surrender value of a policy is the amount that the insurance company will pay the policyholder should he surrender the policy at any time before maturity. Such a course would involve the policyholder in a considerable loss which may be avoided by obtaining a loan from the insurance company.

Dr. **Endowment Policy** *Cr.*

			£	s.	d.				£	s.	d.
Year 1 (commencement)	To Cash—Premium		274	16	11	Year 1 (end)	By Balance	c/d	283	1	9
(end)	,, Interest on £274 16s. 11d. at 3% per annum[1]		8	4	10						
			£283	1	9				£283	1	9
Year 2 (commencement)	To Balance	b/d	283	1	9	Year 2 (end)	By Balance	c/d	574	13	5
,,	,, Cash—Premium		274	16	11						
(end)	,, Interest on £557 18s. 8d. at 3% per annum		16	14	9						
			£574	13	5				£574	13	5
Year 3 (commencement)	To Balance	b/d	574	13	5	Year 3 (end)	By Cash		875	0	0
	,, Cash—Premium		274	16	11						
(end)	,, Interest on £849 10s. 4d. at 3% per annum[2]		25	9	8						
			£875	0	0				£875	0	0

Dr. [3] **Asset Amortization** *Cr.*

			£	s.	d.				£	s.	d.
Year 1 (end)	To Balance	c/d	283	1	9	Year 1 (end)	By Profit and Loss Account		274	16	11
							,, Endowment Policy Account		8	4	10
			£283	1	9				£283	1	9
Year 2 (end)	To Balance	c/d	574	13	5	Year 2 (commencement)	By Balance	b/d	283	1	9
						(end)	,, Profit and Loss Account		274	16	11
							,, Endowment Policy Account		16	14	9
			£574	13	5				£574	13	5
Year 3 (end)	To Transfer to Asset Account		875	0	0	Year 3 (commencement)	By Balance	b/d	574	13	5
						(end)	,, Profit and Loss Account		274	16	11
							,, Endowment Policy Account		25	9	8
			£875	0	0				£875	0	0

[1] As the premiums are calculated to the nearest penny, there will be trivial discrepancies in the interest.

[2] In practice, the Interest "earned" will not necessarily be 3 per cent per annum.

[3] Alternatively the Account may be described as a Sinking Fund.

Dr. ENDOWMENT POLICY *Cr.*

			£	s.	d.				£	s.	d.
Year 1 (commencement)	To Cash—Premium		274	16	11	Year 1 (end)	By Asset Amortization Account		244	16	11
						,,	,, Balance (Surrender Value)	c/d	30	0	0
			£274	16	11				£274	16	11
Year 2 (commencement)	To Balance	b/d	30	0	0	Year 2 (end)	By Asset Amortization Account		79	16	11
	,, Cash—Premium		274	16	11	,,	,, Balance (Surrender Value)	c/d	225	0	0
			£304	16	11				£304	16	11
Year 3 (commencement)	To Balance	b/d	225	0	0	Year 3 (end)	By Cash		875	0	0
(end)	,, Cash—Premium		274	16	11						
	,, Asset Amortization Account		375	3	1						
			£875	0	0				£875	0	0

Dr. ASSET AMORTIZATION *Cr.*

			£	s.	d.				£	s.	d.
Year 1 (end)	To Endowment Policy Account		244	16	11	Year 1 (end)	By Profit and Loss Account		274	16	11
,,	,, Balance	c/d	30	0	0						
			£274	16	11				£274	16	11
Year 2 (end)	To Endowment Policy Account		79	16	11	Year 2 (commencement)	By Balance	b/d	30	0	0
,,	,, Balance	c/d	225	0	0	(end)	,, Profit and Loss Account		274	16	11
			£304	16	11				£304	16	11
Year 3 (end)	To Transfer to Asset Account		875	0	0	Year 3 (commencement)	By Balance	b/d	225	0	0
						(end)	,, Profit and Loss Account		274	16	11
							,, Endowment Policy Account		375	3	1
			£875	0	0				£875	0	0

It will be seen that in both cases cash is available for £875, and the asset of £1,000 after making the transfer in the third year of £875 stands at £125.

(6) **Revaluation Method.** By this method the asset is revalued each year, any diminution in value being charged to Profit and Loss Account.

Illustration. 1st Jan., 19.., stock of loose tools £500. Purchases during year £150. 31st Dec., 19.., stock of tools £520.

Dr. LOOSE TOOLS *Cr.*

19..			£	19..			£
Jan. 1	To Balance . .	b/d	500	Dec. 31	By [1]Profit and Loss Account (or Production Account): Depreciation .		130
Dec. 31	„ Cash. . .		150		„ Balance . . .	c/d	520
			£650				£650
19..							
Jan. 1	To Balance . .	b/d	520				

Loose tools are frequently treated exactly like stock, the purchases thereof being shown as a separate item. In this case the treatment of the preceding facts would be—

Dr. LOOSE TOOLS *Cr.*

19..			£	19..			£
Jan. 1	To Balance . . .	b/d	500	Dec. 31	By [1]Profit and Loss Account (or Production Account) . .		500
Dec. 31	To Profit and Loss Account: (or Production Account) . . .		520				

Dr. LOOSE TOOLS PURCHASES *Cr.*

19..			£	19..			£
Dec. 31	To Cash (or Sundries) .		150	Dec. 31	By [1]Profit and Loss Account (or Production Account) .		150

(7) **Repairs, Maintenance and Depreciation Fund or Provision.**[2] The method of making a composite yearly charge to cover repairs, maintenance, and depreciation is commonly met with. The excess of the provision created over repairs and maintenance is in reality the provision for depreciation, and should by the time the asset has become merely scrap be adequate to meet the depreciation suffered.

[1] In practice, the employment of loose tools predicates manufacturing or production, and the transfer would be to Manufacturing or Production Account, and shown thus—

Debit side of Production Account:
Loose Tools—

Opening Stock	£500	
Purchases	150	
	650	
Less Closing Stock	520	
		£130

[2] In accounts not governed by the Companies Act, 1948, this may be referred to as a Reserve (see page 192 and footnote on page 75).

Hence, such provision must at the end of the life of the asset be equal to the difference between its cost price and its residual value. The book-keeping entries are—

(1)	Debit Profit and Loss Account Credit Provision for Repairs, Maintenance and Depreciation	with yearly charge
(2)	Debit Provision for Repairs, Maintenance and Depreciation Credit Cash	for repairs and maintenance

Illustration. A yearly sum of £400 is set aside to cover repairs, maintenance, and depreciation. The expenses for repairs and maintenance in the first two years are £30 and £47. Show Repairs, Maintenance and Depreciation Provision Account

Dr PROVISION FOR REPAIRS, MAINTENANCE AND DEPRECIATION *Cr.*

			£				£
Year 1	To Cash—Repairs, etc		30	Year 1	By Profit and Loss Account		400
	,, Balance .	c/d	370				
			£400				£400
Year 2	To Cash—Repairs, etc		47	Year 2	By Balance . .	b/d	370
	,, Balance	c/d	723		,, Profit and Loss Account		400
			£770				£770
				Year 3	By Balance .	b/d	723

(8) **Depletion Method.** In the case of concerns owning wasting assets, provision for the depletion of such assets is sometimes made by means of a charge to Profit and Loss Account per unit of asset extracted

Illustration. The cost of a mine is £30,000 and the estimated quantity of payable ore in tons is 300,000. The first and second years' output: 500 tons and 1,600 tons. Show Mine Account assuming residual value of the Land to be worth nothing. (This illustration appears on p. 188.)

In reference to this topic it should be noted that the lessee of the mine will usually be liable to pay compensation to the lessor at the end of the lease for spoiling the land, and consequently will probably build up a compensation provision or fund.

[The same principle applies in the case of a machine, e g 6d an hour where the estimated running hours of the machine's life are 50,000 and the cost of the machine £1,250 (machine hour rate): or instead of the rate being fixed at 6d. an hour, the first year may be charged with, say, 8d an hour, the second with 6d, and so on in subsequent years, the rate diminishing in ratio to the machine's loss of efficiency (efficiency hour rate).]

Dr. MINE *Cr.*

			£				£
Year 1	To Cash . . .		30,000	Year 1	By Profit and Loss Account (or Production Account) Depletion: $\frac{500}{300,000} \times$ £30,000		50
					" Balance . .	c/d	29,950
			£30,000				£30,000
Year 2	To Balance. .	b/d	29,950	Year 2	By Profit and Loss Account (or Production Account) Depletion: $\frac{1,600}{300,000} \times$ £30,000		160
					" Balance . .	c/d	29,790
			£29,950				£29,950
Year 3	To Balance. . .	b/d	29,790				

(9) **Renewals.** By this method the original asset remains in the books at the original cost and the cost of replacement is charged as an expense. The method does not conform to good accounting practice and is criticized on two grounds: (1) That the value of the original asset will by no means equal that of the one replacing it; and (2) that there is an uneven distribution of the burden of depreciation, as only in the year of replacement does revenue bear the renewal charge, entirely relieving most of the years and overcharging that in which the replacement takes place.[1]

Illustration. The cost of an original asset is £480. Three years later it is replaced by an asset costing £570. How are these dealt with on the Renewals system?

The former remains as an asset and the latter is debited to the Profit and Loss Account.

The Life of an Asset. The proportion to be written off in respect of depreciation depends, as has been seen, to a large extent on the estimated life of the asset, but it must be noted that certain assets, e.g. patents, copyrights, mining leases, etc., have, as it were, two "lives," viz. (*a*) legal life, e.g. the lease of a mine, and (*b*) commercial life, e.g. profitable working life of a mine. Depreciation must obviously be calculated on the shorter of the two "lives."

Recommendations. The attention of the reader is drawn to the Recommendations[2] of the Institute of Chartered Accountants on the Depreciation of Fixed Assets, of which the following is a summary—

(1) Consistent bases should be used from one period to another.

(2) Where practicable, fixed assets at the date of the Balance Sheet should be shown at cost, less the aggregate provisions to date for depreciation, etc. (*vide* the requirements of the Companies Act, 1948.)

[1] This criticism may, however, be overcome by setting up a Provision for Renewals with an annual charge to Profit and Loss Account, renewals being debited to the Provision.

[2] It will be realized that these apply particularly to companies rather than to partnerships and sole traders.

(3) If additional provisions are necessary, they should be shown separately in the Profit and Loss Account.

(4) Recommended bases—

Asset	*Basis*
(*a*) Goodwill and Freehold Land.	Depreciation does not normally arise, except as in (*d*). Any special provision should be shown separately in the Profit and Loss Account.
(*b*) Freehold Buildings, Plant and Machinery, Tools and Equipment, Ships, Transport Vehicles, and similar assets subject to depreciation by use.	Normally on the straight-line method, but loose tools, jigs and patterns, etc., having a very short effective life may be revalued (not exceeding cost).
(*c*) Leaseholds, Patents, and other assets exhausted by effluxion of time.	Straight-line method, with provision for estimated dilapidations for leaseholds. The annual premium on Leasehold Redemption Policy is a fair charge for amortization.
(*d*) Mines, Oil wells, Quarries, and similar wasting assets consumed as basic raw material or output of which is sold as such.	Depletion method. If not charged, the fact should be revealed to warn members that dividends are in part return of capital.

(5) Where a non-recommended method has been adopted to date and it is not practicable to change for existing assets, the recommended methods should be adopted for assets subsequently acquired.

(6) Amounts set aside out of profits for unforeseeable obsolescence or possible increase in replacement cost are matters of financial prudence; they are reserves, not provisions (see page 192).[1]

(7) Details of cost, amounts and basis of provision for depreciation should be kept for each fixed asset, preferably in registers.

Plant Registers. Following on the last point above, it is essential in any large concern that adequate records should be kept in respect of Plant and Machinery. A separate record may be kept for each machine, the following information being shown—

(1) Description—type, number, maker, etc.
(2) Where situated.
(3) Purchase—date, from whom, cost, cost of erection, etc.
(4) Alterations and Additions, Repairs and Renewals.
(5) Depreciation—basis, annual rate, amounts and aggregate.
(6) Sale—date, to whom, price, profit or loss on sale.
(7) Taxation—Rate of wear and tear allowance, initial and annual allowances, balancing allowance or charge.
(8) An engineer's report is sometimes included.

[1] Many accountants hold that in times of rising prices profits are overstated unless arrived at after charging depreciation based on replacement rather than historical cost. It is, however, recommended that the extra charge to cover increased costs should not be regarded as an essential, provision but rather as a transfer to reserve. If this additional amount is charged before striking the balance of profit, such balance should be suitably described.

Sinking Fund for Depreciation and Redeeming Debenture. It may here be convenient to contrast the position arising in the case of a Sinking Fund created by way of amortization of an asset and that created when a liability is to be repaid. The latter arises chiefly in connection with debentures of a limited company, which will be dealt with fully in Chapter XXIII, but for the present the debenture may be considered in the light of a loan.

The positions are shown by means of the following table—

	SINKING FUND to write off asset	SINKING FUND to "redeem" a liability
(1) On setting aside the instalment annually	Debit Profit and Loss Account Credit Sinking Fund	Debit Profit and Loss APPROPRIATION Account Credit Sinking Fund
(2) On investing the instalment	Debit Sinking Fund Investment Credit Cash	Same as Sinking Fund to write off Asset
(3) On receipt and reinvestment of interest on investment	Debit Cash Credit Sinking Fund Debit Sinking Fund Investment Credit Cash	Same as Sinking Fund to write off Asset
(4) On the expiry of the life of the asset	Debit Sinking Fund Credit Asset	Not applicable
(4a) On the purchase of new asset	Debit Cash Credit Sinking Fund Investment Debit (new) ASSET Credit Cash	Not applicable
(5) On the redemption of debentures	Not applicable	Debit Cash Credit Sinking Fund Investment Debit DEBENTURES Credit Cash Debit Sinking Fund Credit General Reserve

The essential differences are—

(1) The amount set aside for the Sinking Fund for writing off the asset is debited to the Profit and Loss Account; for the redemption of debentures it is debited to the Appropriation Account.

The difference in treatment is explained by the fact that one is a definite charge for depreciation, and the other merely an appropriation to prevent the amount set aside from being distributed as dividends until the debt is repaid.

(2) When the asset is written off, the fund and the asset disappear, and until purchase of the new asset is made the investment (or cash if the investment is realized) remains; but in the case of the repayment of the debenture the investment and the debenture disappear (as the investment is converted into cash which is used to repay the debt), but the fund remains and is now "free," i.e. it is available for distribution. As has been seen in (1), the fund was created solely to prevent the amount represented thereby being distributed in dividends until the repayment of the debentures. Although the expression "redeeming by means of Sinking Fund" is convenient, it is not strictly accurate, as it is CASH that redeems the liability.

In practice, of course, it does not follow that the cash realized from the Sinking Fund investment (which equals the original value of the old asset) will be sufficient to defray the cost of the *new* asset.

Illustration. A company borrows £20,000 by debentures and agrees to redeem the whole sum at the end of five years by means of a Sinking Fund.

At the end of the period the relevant accounts will be—

Dr DEBENTURES *Cr*

			£				£
	To Cash . . .		20,000		By Balance . .	b/d	20,000

Dr. SINKING FUND *Cr.*

			£				£
	To Reserve . .		20,000		By Balance . . (*instalments debited to Profit and Loss Appropriation Account*)	b/d	20,000

Dr SINKING FUND INVESTMENT *Cr.*

			£				£
	To Balance . .	b/d	20,000		By Cash . . .		20,000

Dr CASH *Cr.*

			£				£
	To Sinking Fund Investment		20,000		By Debentures		20,000

Dr RESERVE *Cr.*

							£
					By Sinking Fund		20,000

It will be noted that the Debentures and Investment Account disappear, the Sinking Fund being transferred to Reserve.

If an asset is to be replaced at the end of five years by the utilization of a Sinking Fund, the relevant accounts will be—

Dr. ASSET *Cr.*

			£				£
	To Cost . . .		20,000		By Sinking Fund		20,000

Dr. SINKING FUND Cr.

To Asset . . .		£ 20,000		By Balance . . . *(instalments debited to Profit and Loss Account)*	b/d	£ 20,000

Dr. SINKING FUND INVESTMENT Cr.

To Balance. . .	b/d	£ 20,000		By Cash . . .		£ 20,000

Dr. CASH Cr.

To Sinking Fund Investment . .		£ 20,000				

It will be perceived that the asset and fund accounts disappear, the cash (realized from the investment) remains, pending the acquisition of the new asset.

The question of profit or loss on the realization of the Sinking Fund Investment is dealt with in Chapter XXIII.

It will be clear that the Sinking Fund instalment in the case of debentures is an *appropriation* of profits ; in the case of the amortization of an asset a *charge against* profits.

RESERVES AND PROVISIONS

The lack of uniformity and looseness in the past in the employment of the term "reserve" have tended not only to create confusion in the mind of the student but to difficulties in the proper understanding of the financial position of businesses as shown in their Balance Sheets. The matter has now been considerably clarified by the Companies Act, 1948, and although the requirements of the Act (which will be stated in detail in a later chapter) apply only to limited companies, it is proposed in this chapter to deal with reserves and provisions on the lines of the definitions laid down in the Act. The reader should, however, bear in mind that at this stage the matter is being considered more in broad principle than in regard to the specific requirements of the Act which apply to the published accounts of limited companies.

As a preliminary to closer study, reserves and provisions may be defined as follows—

(1) *Reserves*—amounts set aside out of profits and other surpluses which are not designed to meet any liability, contingency, commitment or diminution in value of assets known to exist at the date of the Balance Sheet.

(2) *Provisions*—amounts set aside out of profits and other surpluses to provide for

(*a*) depreciation, renewals or diminution in value of assets, or

(*b*) any ***known*** liability of which the amount ***cannot*** be determined with substantial accuracy.

It follows therefore that—

(1) Any amount set aside for the purposes described in (2) (*a*) and (*b*) (above) in excess of estimated requirements must be regarded as a reserve, and

(2) Sums set aside to meet known liabilities of which the amount ***can*** be determined with substantial accuracy do not fall within the definition of a provision and should therefore be described as accruals or accrued liabilities.

Reserves are in effect part of the undistributed profits of the business and therefore part of the proprietorship, whereas provisions and accruals are a diminution of proprietorship in the form of a liability or diminution of an asset. The former are broadly appropriations of, the latter charges against, profits.

RESERVES

Reserves are, with special reference to limited companies, divided into two main classes, depending upon whether or not they may be regarded as arising from normal profits or gains available for distribution through the Profit and Loss Account as dividends. They are—

(1) **Capital Reserves.** These are not, in limited company accounting, normally regarded as available for distribution as dividend; such reserves arise from—

(*a*) Sale of fixed assets at a profit over book values.
(*b*) Profit of a company accrued before incorporation or purchase.
(*c*) Premium on shares or debentures.
(*d*) Profit on redemption of debentures.
(*e*) Profit on forfeiture of shares.
(*f*) Profit on revaluation of assets and liabilities.
(*g*) Capital Redemption Reserve Fund.

These matters are dealt with in more detail in Chapter XXIII, but it may be stated broadly that in certain circumstances some of these profits *may* be considered as revenue but the better practice is to regard them as Capital; others are subject to special restrictions and treatment in accordance with the provisions of the Companies Act.

(2) **Revenue Reserves.** These are normally regarded as available for distribution through the Profit and Loss Account, but are themselves divided into two classes—those immediately and those not immediately so available—

(i) *General Reserve.* This reserve is created by setting aside profits in order to strengthen the general financial position of the business. Such profits, however, remain available for distribution, and for this reason it is often described as a "free" reserve. In this

group should be included any undistributed balance of the Profit and Loss Account (by deduction, if a debit balance).

(ii) *Specific Reserve.* Under this heading are included amounts set aside out of profits for a specific purpose or because of a specific obligation, which, though still revenue, are not immediately available for distribution. The best example of this arises in the accounts of limited companies when a company engages to set on one side a portion of profits until debentures—which for this purpose may be considered the equivalent of a loan—are repaid; throughout the whole period of liability in respect of the loan, the reserve set aside is part of the undistributed profits and upon repayment of the loan may be transferred back to the Profit and Loss Account or to the General Reserve.

Capital, Specific and General Reserves should be separately stated in the Balance Sheet, the first two being subdivided, where necessary, under appropriate headings. Furthermore, sufficient detail should be given to show how increases and decreases have arisen and how the reserves have been utilized.

So far, consideration has been confined to reserves which are shown as such in the Balance Sheet. There may, however, be reserves which are not disclosed therein—

(1) *Hidden Reserves*, where an item of profit is described in such a manner as to indicate a liability, being included for instance in Sundry Creditors.

(2) *Inner Reserves*, where a provision is made to cover exceptional and abnormal losses, and such provision is not openly disclosed, e.g. general contingencies reserve (in the case of a bank) included in creditors, usually under the heading of "Deposit, Current and other accounts."

(3) *Secret Reserves*, where the net asset position is stronger than that disclosed by the Balance Sheet by reason of—

(*a*) Excessive depreciation of an asset, or excessive valuation of a liability.

(*b*) Complete elimination of an asset; undervaluation or understatement of an asset.

(*c*) Charging capital expenditure to revenue, or crediting revenue receipts to an asset (e.g. dividends received and earned credited to the investment).

(*d*) Permanent appreciation in a fixed asset, or permanent diminution or extinction of liability not recorded.

(*e*) Showing a contingent liability as an actual liability or as a provision therefor; or an actual asset as a contingent asset.

(*f*) Grouping of "free" reserves with creditors.

(*g*) Deliberately withholding sales till succeeding period; or taking delivery of goods on forward contract on a falling market.

An excellent example of the creation of a secret reserve is seen in the case of banks which invariably provide for depreciation of investments but do not re-credit an appreciation of investments.

From this it will be seen that secret reserves may

(i) arise, as in (*d*),

(ii) be created, as in the remainder of the examples given,

(iii) be maintained, by allowing (i) to remain or by continuing the practice in (ii).

It may here be noted that the Companies Act, 1948, contains provisions which aim at preventing the creation of secret reserves; this is dealt with more fully in Chapter XXIII.

Reserve Fund. The word "fund" is frequently employed in substitution for the word "account." In the minds of the public the use of the word "fund" usually signifies that on the assets side of the Balance Sheet the reserve is represented by specifically earmarked investments, e.g. in gilt-edged securities, but whilst it is advisable to do so in certain specific instances, e.g. in a Sinking Fund for the amortization and *subsequent replacement* of a lease, there is no obligation to make such an outside investment to justify the use of the word "fund"; indeed, in many instances the utilization of the resources "in" rather than "outside" the business is essential to its proper development, so that unless it is necessary to be in a position to have liquid assets available at a specific date the policy of "outside" investment is short-sighted. Naturally, the nature of the business and the purpose of the reserve will determine whether it is necessary to have liquid assets available at short notice.

However, in order to avoid confusion, it is recommended that the term "Reserve Fund" should only be used where a reserve is specifically represented by readily realizable and earmarked assets.

PROVISIONS

Provision will be required in the final accounts for (1) Depreciation and diminution in value of assets, and (2) Estimated and anticipated liabilities which exist at the date of the Balance Sheet, e.g. claims for delay in delivery of goods, accident and employer's liability claims, estimated bad and doubtful debts (these may be regarded as coming under the heading in (1) of diminution in value of assets), etc.

These provisions will be normally either deducted on the assets side of the Balance Sheet (as in the case of depreciation and bad and doubtful debts) or grouped on the liabilities side under appropriate sub-headings, unless in the published accounts it would be detrimental to the company's interests for a provision to be openly disclosed, e.g. a provision against a disputed claim.

Where any provision is used for a purpose other than that for

which it was created, this fact should be shown, and when any provision becomes redundant it should be credited back to the Profit and Loss Appropriation Account.

Contingencies. Amounts set aside in respect of contingencies may be in the nature of a reserve, or a provision, or what is termed a contingent liability.

(1) **Contingency Reserve.** Amounts are sometimes set aside out of profits under this heading although there are no actual, probable or really possible contingencies at the date of the Balance Sheet. There is thus little or no difference between such a reserve and a General Reserve as already described, and the two may well be shown together.

(2) **Contingency Provision.** As already stated provision should be made for all known contingencies, even if the amount can only be estimated, existing at the date of the Balance Sheet, e.g. under employer's liability, to cover possible claims against accidents which have already occurred.

(3) **Contingent Liabilities.** Where there exists a possibility that upon the happening of a contingency an actual liability will arise, it is not usual to make any provision for the possibility in the accounts. It is the practice to call attention to the possible liability by way of a footnote in the Balance Sheet. Examples of contingent liabilities are bills under discount and calls on shares in limited companies, which will be dealt with later.

It does not follow necessarily that even if the contingency does arise it will involve a loss. The liability incurred may be reflected in an asset, e.g. the call on the share may arise because the company is in difficulties, in which case the liability incurred will probably be considered a loss; but if the calls are made in the ordinary course of events, the liability incurred will be reflected in an increase in the value of the assets.

As has already been stated any amount set aside in excess of a necessary provision is a reserve and should be shown as such in the Balance Sheet. For example, in regard to Stock, the amount required to cover the excess of cost over market value is a provision; any further amount set aside, e.g. to minimize the effect of a possible future fall in values, is a reserve.

It will be realized that this new nomenclature of reserves and provisions supersedes the old method of dividing reserves into (1) external and (2) internal, the latter a setting aside of profits within the business, the former providing for (external) liabilities. The subdivision of the old "External" reserve in which the amount of the liability was known does not now fall under the definition of a provision and must be described as an accrued liability. Such accruals have been dealt with in Chapter V.

CHAPTER VIII

CAPITAL AND REVENUE EXPENDITURE

BEFORE each term is discussed it is sufficient to say that revenue expenditure constitutes a charge against profits, and must be debited to Profit and Loss Account, whereas capital expenditure is treated as a capital charge, and is shown upon the assets side of the Balance Sheet.

It is a matter of extreme difficulty to lay down a hard and fast rule as to what dividing line separates capital expenditure from revenue expenditure. There is much divergence of opinion and practice on this matter, and *inter alia* the following *indicia* have been laid down as establishing the fact that the expenditure is capital.

(1) Any expenditure which is undertaken for the purpose of increasing profits either positively by way of INCREASING earning capacity, or negatively by DECREASING working expenditure, is capital expenditure. The formal acquisition of a tangible asset is not a necessary element in this rule. For example, owing to increased demand for seats, a theatre reconstructs the auditorium; such expenditure may be capitalized.

(2) If the expenditure, whether increasing the earning capacity or not, produces an asset comparatively permanent in character, it is capital expenditure.

Capital expenditure, therefore, may be described as outlay resulting in the increase or acquisition of an asset or increase in the earning capacity of a business.

Revenue expenditure, on the other hand, is such outlay as is necessary for the MAINTENANCE of earning capacity, including the upkeep of the fixed assets in a fully efficient state, and the normal total cost involved in selling, including the cost of goods and services of the business to which it relates.

In short, if the purpose of expenditure is to MAINTAIN the business it is revenue; if it is to IMPROVE the business it is capital.

Improvements. The judicial view is that the cost of an improvement of an asset is a legitimate capital charge quite irrespective of whether it is by way of mere substitution or is entirely new. The accounting view is that in regard to the former, i.e. the substitution, the EXCESS of the value of the new over the old asset is the only amount that can properly be charged to capital. The former view is that the original asset was necessary before the improvement could be made. Although this view may be tenable in extreme instances, it is not supported by the vast majority of accountants. It is important, however, in that when the question of whether a dividend has been improperly paid out of capital arises in the case of limited companies, the procedure of capitalizing an improvement

by way of substitution, contrary though it be to prudence, may be supported and justified on LEGAL grounds.

Capital Expenses. Certain expenses are recognized as being of a capital nature, although no tangible property may have been acquired as a result. The most important are—

(1) Preliminary expenses of a limited company.

(2) Cost of issuing shares and debentures: procuration and legal fees on loans and mortgages.

(3) The initial outlay as well as the losses in the early years of concerns which by their very nature require a very long period of development, e.g. rubber and other plantations, mines, etc.

(4) Cost of experiments.

(5) Advertising where its nature is to INTRODUCE a line or "boost" a new business.

(6) Interest on construction capital.

(7) Renewals in public utility companies, where, for instance, steam engines of a railway are replaced by electrical equipment.

(8) Legal expenses incurred in the acquisition of property.

(9) "Repairs" on purchase of a dilapidated asset to put it into workable condition.

(10) Additions to property and other assets.

Capital and Revenue Receipts. Capital receipts may be said to consist solely of additional payments into the business, made either by shareholders of a company or by proprietors of a business, and receipts from the sale of any fixed assets of a business (not being in the nature of a normal sale). Most receipts, with comparatively few exceptions, may be treated as revenue receipts, e.g. sales, income from investments, transfer fees, commissions and discounts received, etc.

It should be noted that in taxation and double account questions the distinction between capital and revenue receipts and expenses is of extreme importance, and is based on principles that do not necessarily coincide with those already enumerated.

It is not always possible by mere inspection to distinguish between capital and revenue expenditure for many reasons, the chief being that—

(1) Certain expenses are in the nature of capital for some businesses and of revenue for others.

(2) Certain expenses may be said to be partly capital and partly revenue. If in doubt as to the nature of any item candidates should always make a note at the foot of the question as to the method of treatment adopted, though the question should always be scrutinized for any information as to the nature and circumstances of the business.

Although in general it may be said that all expenditure laid out in the purchase of land, buildings, plant, and machinery and other assets of a similar type is in the nature of capital expenditure, the actual circumstances must be considered in each case. Taking the illustration of an engineering business, some plant and machinery

may have been purchased with the object of earning profits (capital expenditure), and other amounts may have been purchased for the purpose of re-sale (revenue expenditure). Again, in the case of real estate business, most land and buildings purchased are revenue expenditure, as they may be considered as trading assets, subject to the obvious qualification that (1) purchases for own occupation; and (2) for permanent holding or for letting purposes, are in the nature of capital expenditure.

In certain cases the policy of those in charge of the business will decide whether certain expenditure may be classed as revenue or capital. Although expenditure will generally be capable of strict classification, yet where the true nature of such expenditure is doubtful, it is preferable to charge it to revenue, as the charging of revenue expenditure to capital may involve very serious consequences. If capital expenditure is wrongly charged to revenue the resulting effect is an understatement of profits; but if revenue expenditure is wrongly charged to capital, the profits will be overstated, resulting maybe in the withdrawal of such inflated profits by the proprietors.

Legal Expenses. These are nearly always a revenue expense, but legal charges incurred in connection with the purchase of property or other assets may be said to be merely an addition to the price of the asset and accordingly may be capitalized.

Wages. Wages which are paid to employees in the construction of the fixed assets of the business are in the nature of part of the cost of the asset and should be transferred from Wages Account to the debit of the asset account, e.g. if a firm of building contractors decides to enlarge its own premises, all the wages and the materials consumed for this purpose should be debited to the Premises Account. Such facts in an examination will readily suggest that *in addition* a transfer from purchases in respect of materials used is required. The business may, however, charge such expenditure to revenue, thus creating a secret reserve. The charging of capital expenditure of the above nature to revenue will not be allowed as a charge for TAXATION purposes.

Many questions are set involving the problem of a business constructing its own assets, e.g. suppose the cost of a new asset is £10,000, whilst the lowest outside quotation is £12,000; then the question to consider is "should the latter amount be capitalized?"

In no case can it be considered a sound financial policy to charge up the asset with the additional £2,000, taking credit for profit of that amount, such money saved not being in the nature of profit, since a business cannot make a profit out of itself. On the other hand, if the outside quotation were £8,000, only this lower figure should properly be capitalized, the excess of the cost over this figure (£2,000) being written off as soon as possible.

Repairs. Repairs are usually in the nature of a revenue charge, though an instance of their being capital expenditure may be seen

in the purchase of second-hand assets, and the subsequent repair by the purchaser to put them into an efficient state. Such an expense is capital, and must be transferred to the Asset Account, even if outside labour be employed. The problem often arises where plant and machinery which is still in good working order is sold at a considerable loss, and replaced by new machinery of a more modern type. Whether the loss should be written off or added to the cost of the new machinery is a very debatable point. There is no legal compulsion in the case above-mentioned to write off a loss of this type to revenue, though unquestionably the soundest policy is to write off such loss during the accounting period in which it is incurred, as the profits will have been previously overstated. If no balance remains on Profit and Loss Account (e.g. because all the profits have been withdrawn), the treatment is either to charge future years with the loss or to deduct the amount from capital.

DEFERRED REVENUE EXPENDITURE

There is a class of expenditure known as deferred revenue expenditure, i.e. revenue expenditure incurred during one accounting period which is applicable either wholly or in part to future periods.

There are four distinct types of deferred revenue expenditure—

(1) Expenditure *wholly* paid for in advance, where no service has yet been rendered, necessitating its being carried forward, i.e. the showing of such outlay as an asset on the Balance Sheet as prepaid expenditure, e.g. telephone rental, rent in advance, etc.

(2) Expenditure *partly* paid in advance where a proportion of the benefit has been derived within the period under review, the balance being as yet "unused," and therefore shown in the Balance Sheet as an asset, e.g. proportion of rates paid in advance or special advertising expenditure incurred in introducing a new line or developing a new market.

Most items paid in advance will fall either under head (1) or (2), according as the payment relates wholly or partly to future periods.

(3) Expenditure in respect of service rendered which for any sound reason is considered as an asset, or more properly, is not considered to be allocable to the period in question, e.g. development costs in mines and plantations; discount on debentures in limited companies and cost of experiments.[1]

The practice which varies considerably in detail is to write off the amount over a period of years. If the expenditure can be earmarked as being in respect of a specific object, the expenditure should be written off during the life of that object, e.g. in the case of debenture discount at the latest by the time the debentures are redeemed.

[1] Usually the reason is that the expenditure is so heavy that it is right and proper to spread it over several years.

(4) Amounts representing losses of an exceptional nature, e.g. property confiscated in a foreign country, heavy loss of non-insured assets through, say, fire.

As a rule an item falling under this heading is a fictitious asset, i.e. although it is shown on the right-hand side of the Balance Sheet, it is not really an asset at all but a capital or abnormal loss which has not been written off.

A few instances will now be given of expenses which, usually of a revenue nature, may occasionally be classed as capital expenditure.

Illustration. The sum of £1,000 has been spent on a machine as follows—

(*a*) £100 for repairs necessitated by negligence and lack of care and attention.

(*b*) £200 for replacements of worn parts.

(*c*) £700 for additions, incorporating new devices which enabled the output to be doubled.

State how these items would be dealt with, as between Capital and Revenue.

Items (*a*) and (*b*) are Revenue, being necessary to keep the asset in efficient running order. They add nothing to the original value of the machine, nor to its proper functioning.

Item (*c*) is a Capital charge because it enhances the earning capacity of the business.

Illustration. Haworth & Co. remove their works to more suitable premises, incurring the following expenditure: (*a*) Cost of dismantling, removing and reinstalling plant, etc. £1,720.

(*b*) Certain old plant standing in the books at £750 was sold for £300 and replaced by new plant costing £1,200.

State how these items should be dealt with, as between Capital and Revenue.

	Capital	Revenue
	£	£
(*a*) Removal Expenses		1,720
(*b*) Plant—		
Loss on sale of old plant		450
Cost of new plant	1,200	
	£1,200	£2,170[1]

Illustration. Carlo, Ltd., a company owning a greyhound racing track, incurs the following expenditure in the first year to 31st December, when they make up their accounts—

(1) Purchase of a totalizator costing £20,000, which, owing to legal actions pending, should not really be in operation. They have incurred fines of £100 through continuing to use the machine, and

[1] The sum of £2,170 could be written off at once, but it would also be quite legitimate to write it off over a short period of years, say, four or five.

£1,000 legal charges have been incurred to enable a Bill to be passed through Parliament to legalize the use of a totalizator.

(2) The stand has been repainted by the track staff, and it is estimated that the wages under this heading, included in general wages, amount to £240.

(3) The rates for the year to 31st March amount to £660. Nothing has yet been paid.

(4) Preliminary expenses were £6,000.

(5) Free tickets have been issued during the year to advertise the track. It is estimated that 200,000 of these tickets have been used on the popular side, the usual price being 1s.

(6) Fire insurance was paid on 25th December for the year following, amounting to £126.

(7) When the track was being constructed several temporary cottages for workmen were built which were demolished upon the completion of the track, the cost being £290.

(1) The cost of the totalizator is clearly a capital charge, as is the cost of introducing the Bill. If, however, the totalizator can never be used the expenditure will be sheer loss, to be written off against profits (if any) as expeditiously as is practicable.

The fines incurred, £100, cannot be capitalized. They are a revenue loss, and must be borne in the current period.

(2) It is evident that the stand (presumably as taken over by the company) was not newly painted, and this painting may be thus considered as part of the capital cost. A transfer of £240 should be made from Wages Account to the debit of the Stand Account.

(3) Rates £660. Nine months' rates have accrued, and thus $\frac{9}{12} \times$ £660 = £495 must be charged to revenue, and shown in the Balance Sheet as a liability.

(4) Preliminary expenses £6,000. This item will be capitalized but should be gradually written down, as it is unrepresented by tangible assets.

(5) Free tickets £10,000. Although this represents advertising which will probably benefit future periods, it would be difficult to attach any figure of cost to it, it being rather a loss of revenue. It would therefore be imprudent to capitalize the £10,000 and write it off over several years. There will probably be no entry in the books in respect of the item but, if desired, the amount could be credited to Revenue Account to show a full gross profit and then written off by debit to Profit and Loss Account.

(6) Fire insurance £126. The major part of this item represents a prepayment, as only 6 days out of the 365 covered by the payment can be treated as current expenditure: $\frac{6}{365} \times$ £126 = £2 1s. 5d. The balance of £123 18s. 7d. will be carried forward.

(7) Temporary cottages £290. This item may be considered as part of the cost of construction of the track, and thus capitalized. The receipts (if any) in respect of the demolished cottages must be credited to the cost of construction.

EXAMINATION QUESTION

The following is a summary of the Alpha Brickyard Account for the years ended 31st December, 1952 and 1953, in the books of Brickmakers, Ltd.

Dr. *Cr.*

	1952		1953			1952		1953	
	Bricks		Bricks			Bricks		Bricks	
		£		£			£		£
Stock, 1st Jan.	250,000	450	100,000	175	Sales	1,600,000	3,280	850,000	1,785
Wages		1,500		2,320	Stock, 31st Dec.	100,000	175	100,000	170
Salaries		250		550	Bricks spoiled	50,000		50,000	
Coal, Stores, Plant, etc.		775		2,950	Used for New Kiln			700,000	
Royalties, Rates, Head Office Expenses and Sundries		225		354	Balance				4,394
Profit		255							
		£3,455		£6,349			£3,455		£6,349

In 1953 work was begun on the building of a new kiln by the company's own labour, the expenditure being included in the above account.

You ascertain—

(*a*) That no particulars have been kept of the wages incurred in the building; men were sometimes diverted to the work for part shifts, while the foundations were dug in clay, which was used for brick making in the existing kiln.

(*b*) That it may be taken that the wages-cost per *thousand* bricks in 1953 was lower by 5 per cent than in 1952

(*c*) That £350 of the salaries, £2,100 of the plant, and £100 of the head office expenses should be capitalized.

(*d*) That sundries included Employer's Liability Insurance at a premium of 10s. per cent of capital wages.

Show the amounts you would transfer to capital expenditure or elsewhere, and construct the Alpha Brickyard Account for the year 1953.

(*Institute of Chartered Accountants Final.*)

It is first necessary to appreciate the significance of the question. The expenditures outlined are made up both of capital and revenue, so that the object is to separate them. In constructing the kiln, naturally, the bricks manufactured by the company will be utilized instead of making a purchase.

The cost of making the bricks is made up of materials, labour, and expenses, hence the first objective is the cost per 1,000 bricks. Then it will be observed that some are sold, some retained in stock, and some transferred, as it were, to another department, i.e. the "Construction" Department.

The cost of bricks is ascertained as follows—

(1) **Wages-cost of Making Bricks—**

(*a*) Cost per 1,000 bricks in 1953—a reduction of 5 per cent on 1952 cost.

Cost per 1,000 bricks in 1952—

$$= \frac{\text{Wages paid}}{\text{Bricks produced}} \times 1{,}000$$

$$= £\frac{1{,}500}{(1{,}750{,}000 - 250{,}000)} \times 1{,}000$$

$$= 20\text{s.}$$

1953 cost per 1,000 bricks = 20s. less 5% thereof,

= 19s.

(b) Bricks produced are 1,600,000 (i.e. 850,000 + 100,000 + 50,000 + 700,000 – 100,000).

(c) Bricks produced for sale are 1,600,000
Less used for new kiln 700,000
900,000

	£
(d) The wages chargeable to production of bricks for sale are 900,000 at 19s. per 1,000	855
(e) The wages chargeable to production of bricks for new kiln are 700,000 at 19s. per 1,000	665
Total wages for bricks produced	1,520
(f) ∴ Wages on construction of kiln (see par. 4)	800
Accounting for wages item of	£2,320

(2) **Cost of Making Bricks**—

	Bricks	£
Stock at commencement	100,000	175
Wages (as above)		1,520
Salaries (£550 – £350) (i) (see par. 4)		200
Coal, Stores, etc. (£2,950 – £2,100) (ii) (see par. 4)		850
[1]Royalties, Rates, etc. (£354 – £104) (iii) (see par. 4)		250
Bricks manufactured	1,600,000	
Total	1,700,000	2,995
Less Stock at end	100,000	170
Gross Production	1,600,000	2,825
Less Spoilage	50,000	
Net Production	1,550,000	£2,825

(3) **Transfer Cost of Bricks to Kiln.**[2] After having arrived at cost of bricks, it is now possible to charge out the 700,000 "sold" to the "Construction" Department; i.e.—

$$\frac{700,000}{1,550,000} \times £2,825 = £1,276 \text{ [to nearest £]}$$

(4) **Cost of Kiln.** Inasmuch as the wages (as per 1 (f)), bricks (as per 3), and other capital costs are known, the compilation of the cost of construction of the new kiln is simply as follows—

		£
Wages	(see par. 1 (f))	800
Bricks[2]	(see par. 3)	1,276
Salaries, etc.	(see par. 2 (i))	350
Plant	(see par. 2 (ii))	2,100
Head Office Expenses	(see par. 2 (iii))	100
Employer's Liability Insurance	(see par. 2 (iii))	4
		£4,630

[1] The item of £104 is Head Office Expenses £100, plus Employer's Liability Insurance of £4 (being 10/- per cent on capital wages of £800).

[2] See footnote[1] on page 205.

Alpha Brickyard Account (Reconstructed)

Dr. for the Year ended 31st December, 1953 *Cr.*

	Bricks	£		Bricks	£
To Stock (opening)	100,000	175	By Stock (closing)	100,000	170
,, Wages		1,520	,, Bricks Spoiled	50,000	
,, Salaries		200	,, Cost of Usable Bricks produced . . c/d	1,550,000	2,825
,, Coal, Stores, Plant, etc.		850			
,, Royalties, Rates, Head Office Expenses and Sundries		250			
,, Bricks Produced	1,600,000				
	1,700,000	£2,995		1,700,000	£2,995
To Cost of Usable Bricks Produced . . b/d	1,550,000	2,825	By Bricks used for New Kiln at Cost[1]	700,000	1,276
			,, Cost of Sales of Bricks c/d	850,000	1,549
	1,550,000	£2,825		1,550,000	£2,825
To Cost of Sales of Bricks b/d	850,000	1,549	By Sales	850,000	1,785
,, Profit		236			
	850,000	£1,785		850,000	£1,785

The above account discloses the results of the operations of the brickyard so far as they relate to trading, and entirely eliminates the entries relating to capital, viz. the cost of constructing the kiln.

In a question of this character the student should at the first perusal obtain a general idea of what is required and proceed to find the first clue, which in this particular illustration is the wages cost of brick making.

Ignoring quantities and intermediate balances carried down, the whole effect may be presented in abridged columnar form—

Dr. *Cr*

	Revenue	Capital	Total		Revenue	Capital	Total
	£	£	£		£	£	£
To Stock	175		175	By Sales	1,785		1,785
,, Wages	1,520	800	2,320	,, Transfer	1,276		
,, Salaries	200	350	550	,, Stock	170		170
,, Coal, Plant, etc	850	2,100	2,950	,, Cost of Kiln		4,630	[2]4,394
,, Royalties, Rates, Head Office Expenses and Sundries	250	104	354				
,, Transfer of Brick Cost		1,276					
,, Profit	236						
	£3,231	£4,630	£6,349		£3,231	£4,630	£6,349
			[3]				[3]

[1] If the assumption is made that only the bricks actually produced during the year are transferred, i e. leaving the opening stock of 100,000 still on hand, the transfer will be based on £2,820 instead of £2,825 as the difference in the value of the 100,000 old bricks (£175 − £170) will be eliminated: the transfer will be $\frac{700}{1550}$ × £2,820 = £1,274. Either assumption is valid

[2] £4630 − £236. [3] As per question.

In order to obtain the desired results, transfers will be made to capital from the accounts presented in the original question, e.g. wages—debit Kiln Account and credit wages with £800, thus reducing the figure of £2,320 to £1,520.

The depletion cost of clay, if known, will be charged up like the other expenses and its due proportion charged to capital.

It is assumed that the spoiled bricks realize nothing.

SUMMARY OF CLASSIFICATION OF EXPENDITURE

The position relating to expenditure may be summarized as follows—

EXPENDITURE

- (*a*) Private
- (*b*) Business
  - (i) Capital
  - Revenue
    - Charge against profits
      - (ii) Wholly current charge
      - (iii) Partly current and partly deferred
      - (iv) Wholly deferred
    - (v) Appropriation of profits

The debits will be as follows—

(*a*) Proprietor's Capital Account.

(*b*) (i) Asset.

(ii) Profit and Loss Account.

(iii) Profit and Loss Account for current proportion.
Deferred Revenue item for carry-forward portion.

(iv) Deferred Revenue item for the whole amount.

(v) Profit and Loss Appropriation Account.

CHAPTER IX

PACKAGES, GOODS ON APPROVAL, C.O.D., VOYAGE ACCOUNTS, PURCHASE TAX, P.A.Y.E.

PACKAGES

THE treatment of packages and packing materials in the accounts will depend upon the policy of the individual concern. This may be—

(1) **Packages Non-returnable.** (a) **Not charged out.** The charge for the packages in this case will be included in the sale price of the goods. A Packages Account should be kept which will be debited with opening stock of packages and purchases and credited with closing stock, the balance, being the expense of packing materials during the period of the accounts, being written off as a distribution expense to Profit and Loss Account, or, if desired, being debited to Trading or Manufacturing Account as part of the cost of putting the goods into a saleable condition.

(b) **Charged out.** Sometimes when packages are non-returnable, a separate charge is made for them. These charges should be entered in a separate column in the Sales Day Book, the total being credited periodically to a Packages Account as in (*a*) above, the balance of which account, being either a profit or loss on packages for the period of the accounts, being transferred to Profit and Loss Account.

(2) **Packages Returnable.** (a) **Not charged out.** The double entry book-keeping will be similar to that in 1 (*a*) above, except that opening and closing stock will be divided between packages in the warehouse and those in the hands of customers. Stock must be brought into the accounts at cost, less adequate depreciation. Further entries will be necessary in the books, however, in order to keep a check on packages. Each package should have an identification number, and columns should be provided in the Sales Day Books and in customers' accounts for these numbers. When goods are sent to a customer, the package number will be entered in the special column in the Day Book and posted to the column on the debit side of the customer's account. When packages are returned, the number will be entered in a book kept for this purpose at the gate; from this book it will be posted to the column on the credit side of the customer's account. Periodical cancellation of numbers appearing on both sides of the account will reveal the numbers of the packages still in the hands of the customer.

(b) **Charged out.** Packages are sometimes charged at cost but more usually at a price in excess of cost in order to cover depreciation, cooperage, repairs, and bad debts. Similarly, credit given

for returns is often less than the price at which the packages are charged out. A time limit is often imposed after which packages are not returnable. There are two methods of dealing with these transactions in the books—

(i) **Packages Trading Account.** A Packages Stock Account and a Packages Trading Account should be opened. Packages "out" should be entered in a special column in the Sales Day Book and debited to customers' accounts, the total of the Sales Day Book column being credited periodically to Packages Trading Account. Returns should be entered in a special column in the Returns or Empties Day Book and credited to customers' accounts, the total of the Day Book column being debited periodically to Packages Trading Account. Packages Stock Account will be debited with (*a*) opening stock, (*b*) purchases and will be credited with closing stock. Adjusting entries will be required, by crediting Packages Stock Account and debiting Packages Trading Account, for—

(1) Packages retained by customers (the charge having already been credited to Packages Trading Account through the Sales Day Book as described above).

(2) Depreciation of Stock and Stock destroyed, scrapped, etc.

At the end of the financial period, a certain number of packages will be still in customers' hands; customers have been charged for them and therefore Sundry Debtors will include this charge, the credit being in Packages Trading Account. Since these packages are returnable at a fixed price, a provision must be created to cover the liability to customers in respect thereof. This is done by debiting Packages Trading Account "above the line," the balance brought down being deducted from Sundry Debtors in the Balance Sheet. The Packages Trading Account may now be balanced off and the resultant profit or loss transferred to Profit and Loss Account.

Illustration. R Ltd. deliver goods to customers in cases (which are valued in the books at 3s.) charging them out at 6s. each and crediting them if returned within a stipulated time limit at 4s. each.

On 1st January, 19.., there were 2,000 cases in stock and 4,200 cases in the hands of customers (all returnable). During the year to 31st December, 19.., 3,000 cases were purchased at 5s., 6,400 were sent out to customers, 4,600 were returned by customers, 60 were destroyed in an accident in the warehouse and 100 were sold as scrap for £5.

On 31st December, 19.., 3,800 cases were in the hands of customers (all returnable).

Show the Ledger entries required in respect of the above transactions.

Cases Stock

Dr

Date		Price	Quantity	£
19. Jan 1	To Stock—			
	In hand . .	3/–	2 000	300
	With customers	3 –	4 200	630
Dec 31	,, Purchases	5 –	3,000	750
			9 200	£1 680
19 Jan 1	To Stock b/d—			
	In hand—old .	3/	40	6
	new	5/–	3,000	7 0
	With customers	3 –	3,800	570

Cr

Date		Price	Quantity	£
19 Dec 31	By Cases Trading Account—			
	Cases retained by Customers .	3/–	2,200	330
	,, Cases destroyed		60[4]	
	,, Cases Sold for Scrap		100	5
	,, Cases Trading Account—			
	Loss on Cases destroyed and scrapped			19[4]
	,, Stock c d—			
	In hand—old	3/–	40[5]	6
	new	5/–	3,000	750
	With Customers	3/–	3,800[6]	570
			9,200	£1,680

Cases Trading Account

Dr

Date		Price	Quantity	£
19 Dec 31	To Customers—			
	Cases returned	4/–	4,600	920
	,, Cases Stock—			
	Cases retained by Customers	3/–	2,200[1]	330
	,, Cases Stock—			
	Loss on Cases destroyed and scrapped			19
	,, Profit and Loss Account—			
	Profit on Hire			420[2]
	Profit on Sale			330[3]
	,, Provision c/d—			
	Cases in hands of Customers	4/–	3,800	760[7]
			10,600	£2,779

Cr

Date		Price	Quantity	£
19 Jan 1	By Provision b/d—			
	Cases in hands of Customers .	4/–	4,200	840[6]
Dec 31	,, Customers—			
	Cases charged out	6/–	6,400	1,920
	,, Profit and Loss Account—			
	Loss on Cases destroyed and scrapped			19
			10,600	£2,779
19 Jan 1	By Provision b/d—			
	Cases in hands of Customers .	4/–	3,800	760[7]

(For footnotes see page 210)

If the new stock is written down to 3s., the closing stock credited would be £1,026 instead of £1,326, and therefore an entry for depreciation (£300) would be made on the credit side of Cases Stock Account and debited to Cases Trading Account. This would be followed by a credit of £300 to the latter account and a debit to Profit and Loss Account; or, more properly, a decrease of £300 in the transfer of profit to Profit and Loss Account, since depreciation should be taken into account before the profit on Cases Trading can be ascertained.

[1] Cases sent out during the year		6,400
Add already out on 1st January		4,200
		10,600
Less returned	4,600	
returnable	3,800	
		8,400
∴ Balance *sold* to customers		2,200

[2] Cases sent out during the year	6,400
Less cases sold to customers (as above)	2,200
∴ Cases out *on hire* during the year	4,200

Profit on Hire, 4,200 at 2s. (6s. less 4s.)	£420
[3] Profit on Sale, 2,200 at 3s. (6s. less 3s.)	£330

[4] Loss on cases destroyed, 60 at 3s.	£9
Loss on cases scrapped, 100 at 2s.	10
(The sale price of scrap 1s. as against cost 3s.)	

It is assumed that the new 5s. cases are intact and that no claim exists for loss of cases by the accident in the warehouse.

[5] Stock of Old Cases on 1st January		6,200
Less Sales to customers	2,200	
Destroyed	60	
Scrapped	100	
		2,360
		3,840

[6] The opening figure of £840 (4,200 at 4s.) is provided in respect of the company's liability to customers for cases not yet returned which have been charged up at 6s. in the previous year.

[7] Similarly, a provision must be created at the end of the year for the same purpose. Sundry Debtors will include the charge for 3,800 cases at 6s., so that the Provision of £760 will be deducted therefrom in the Balance Sheet to show the true Sundry Debtors' figure.

Alternatively, the two accounts may be consolidated into one, but generally this method is not recommended.

(ii) **Packages Reserve Account.** In this alternative method of writing up Packages Accounts, a Packages Stock Account and a Packages Reserve Account are used, the former containing all

entries relating to the stock of packages, the latter being confined to the actual stock movements to and from customers. The entries in Sales Day Books, Returns Books and customers' accounts will be similar to those described in the previous method.

The Packages Stock Account will be debited with opening stock and purchases and will be credited with closing stock and stock destroyed and scrapped. The Reserve Account will be credited with opening provision for returnable packages and with packages charged out to customers, and will be debited with packages returned and closing provision for returnable packages. When packages are retained by (i.e. sold to) customers, they must be eliminated from Stock by crediting Stock Account, the corresponding debit being to Reserve Account (as an offset to the credits to that account for packages charged out). When packages are returnable at a smaller price than that at which they are charged out, there will be a balance on Reserve Account representing profit on hire which must be transferred to Profit and Loss Account by debiting Reserve Account; the corresponding credit may be direct to Profit and Loss or to Stock Account whence it will be transferred to Profit and Loss along with the balance of that account, which will show the profit or loss on packages sold to customers, scrapped and destroyed.

It should be emphasized that the entries mentioned above for profit on hire are confined to the money columns as the quantity of stock is not affected, whereas those for sales of packages must include both quantities and money.

Illustration. Using the same data as in the preceding illustration write up Cases Stock and Cases Reserve Accounts.

As will be seen by reference to the previous illustration, most of the entries in the Cases Stock Account and Cases Reserve Account are the same as in the Cases Stock Account and Cases Trading Account respectively. In addition, there are the two cross transfers (*Dr.* Cases Reserve, *Cr.* Cases Stock) for Profit on Hire (money only) and for Sales to customers (quantities and money). [For the guidance of the student, these transfers are shown in heavy type. See page 212.]

Illustration. On 1st January, 19.. Stock of Packages in hand was £800 (valued in the books at cost less 25 per cent), and £120 in the hands of customers at invoice price, which is cost plus 50 per cent.

For the year ended 31st December, 19.. packages were charged out at cost plus 50 per cent and full credit was given in respect of those returned in good condition.

Packages sent out during the year were £1,600 (invoice price) and Returns (all in good condition) £1,000. Customers retained (and were charged up) Packages at an invoice price of £30. Closing Stock of Packages in hand *at cost* £666 13s. 4d.

Write up Packages Stock and Reserve Accounts.

CASES STOCK

Dr.

Date	Particulars	Price	Quantity	£
19.. Jan. 1	To Stock—			
	In hand	3/-	2,000	300
	With Customers	3/-	4,200	630
Dec. 31	„ Purchases	5/-	3,000	750
	„ Profit and Loss Account—			
	Profit on Hire			420
	Profit on Sale			330
			9,200	£2,430
19.. Jan. 1	To Stock b/d—			
	In hand—old	3/-	40	6
	new	5/-	3,000	750
	With Customers . . .	3/-	3,800	570

Cr

Date	Particulars	Price	Quantity	£
19.. Dec. 31	By Cases destroyed		60	
	„ Cases Sold for Scrap		100	5
	„ Cases Reserve:			
	Cases retained by customers . .	6/-	2,200	660
	Profit on Hire			420
	„ Profit and Loss Account—			
	Loss on Cases destroyed and scrapped			19
	„ Stock c/d—			
	In hand—old	3/-	40	6
	new	5/-	3,000	750
	With Customers	3/-	3,800	570
			9,200	£2,430

CASES RESERVE

Dr.

Date	Particulars	Price	Quantity	£
19.. Dec. 31	To Customers—			
	Cases returned	4/-	4,600	920
	„ Cases Stock:			
	Profit on Hire			420
	Cases retained by customers . .	6/-	2,200	660
	„ Provision c/d—			
	Cases in hands of customers . .	4/-	3,800	760
			10,600	£2,760

Cr.

Date	Particulars	Price	Quantity	£
19.. Jan. 1	By Provision b/d—			
	Cases in hands of customers . .	4/-	4,200	840
Dec. 31	„ Customers—			
	Cases charged out . . .	6/-	6,400	1,920
			10,600	£2,760
19. Jan. 1	By Provision b/d—			
	Cases in hands of customers . .	4/-	3,800	760

As in the preceding illustration, if the stock of new cases is taken at 3s., the profit becomes £450 (instead of £750) less loss £19—£431.

∴ Alternatively, the loss may not be separately shown, the Cases Stock Account being closed by a transfer of £731 (or £431, if new cases are taken in Stock at the close at 3s.).

Dr. **PACKAGES STOCK** *Cr.*

19..		£	19..		£
Jan. 1	To Opening Stock—		Dec. 31	By Packages Reserve—	
	In own hands . .	800		Packages retained .	30
	With Customers .	60[1]		,, Closing Stock—	
Dec. 31	,, Profit and Loss Account	15[4]		In own hands . .	500[3]
				With Customers .	345[2]
		£875			£875
19..					
Jan. 1	To Stock b/d—				
	In own hands . .	500			
	With Customers. .	345			

Dr. **PACKAGES RESERVE** *Cr.*

19..		£	19..		£
Dec. 31	To Packages Stock . .	30	Jan. 1	By Opening Provision b/d .	120
	,, Customers—		Dec. 31	,, Customers—	
	Packages returned .	1,000		Packages charged out.	1,600
	,, Closing Provision c/d .	690			
		£1,720			£1,720
			19..		
			Jan. 1	By Provision b/d . .	690[5]

[1] The opening stock "out" must be the reduced value of £120 (opening provision), viz. 66⅔% of £120 (seeing that the loaded price is 50% of Cost), i.e. £80 less £20 (25% of Cost) = £60.

[2] The closing stock "out" will be 66⅔% of £690, i.e. £460 less £115 (25% Cost) = £345.

[3] The closing stock in own hands is £666 13s. 4d. less £166 13s. 4d. (25% of cost) = £500.

[4] Profit on Sale is £30 less £15 (Stock value is 66⅔% of £30 = £20, less 25% = £15), which is £15, less any provision for repairs and maintenance required.

[5] Deducted from Sundry Debtors in the Balance Sheet.

	£	£	
Proof of Stock Transfers at Cost:			
Opening Stock per account. .	60		
Add 33⅓% to bring up to Cost.	20	80	[£80 – £20 (25%) = £60]
Amounts charged out. . . .	1,600		
Less 33⅓% to reduce to Cost .	533⅓	1,066⅔	[£1,066⅔ + £533⅓ (50%) = £1,600]
		1,146⅔	
Deduct: Returns	1,000		
Less 33⅓% to reduce to Cost . . .	333⅓		
		666⅔	[£666⅔ + £333⅓ (50% = £1,000]
		480	
Sales	30		
Less 33⅓% to reduce to Cost . . .	10		
		20	[£20 + £10 (50%) = £30]
Balance at Cost. . . .		460	
Less 25% Reduction . .		115	
Balance per Accounts . .		£345	

GOODS OUT ON APPROVAL OR SALE OR RETURN

The property in goods out on approval, or on sale or return, does not pass to the buyer until he signifies his acceptance of them to the seller or, without giving notice of rejection, retains the goods beyond an agreed or reasonable time. Such transactions therefore require special treatment in the books; this will depend upon the circumstances in each particular concern, but the following three methods are the usual ones—

(1) **When such transactions are rare.** Although theoretically incorrect, goods out on approval may be treated as sales: the entries should, however, be marked in some way so that provision may be made at the end of the financial period to eliminate any outstanding items from Sales and to reduce such items to cost, or market value, if lower, for inclusion in stock. This may be done by—

(*a*) Debiting Sales Account "above the line" and crediting it "below the line" with the amount of such outstanding items included in Sales and deducting the balance brought down from the Sundry Debtors figure in the Balance Sheet, and

(*b*) Entering the value—at cost or lower market value—of the outstanding items in the Trading Account and Balance Sheet as "Stock in hands of customers."

(2) **Where such transactions are very frequent or of considerable value.** It will be necessary to open up a special set of books, which, though compiled on Double Entry lines, will be outside the ordinary double entry book-keeping, that is to say, memorandum. These will consist of—

(*a*) Goods sent on Approval (Sale or Return) Day Book.

(*b*) Goods on Approval Sold and Returned Day Book—this book will be provided with columns to record separately Sales and Returns.

(*c*) Goods on Approval (Sale or Return) Ledger.

The procedure will be as follows—

(*a*) When goods are sent out, they are entered in the Goods sent on Approval Day Book and posted to the debit of the customer's account in the Goods on Approval Ledger. The Day Book total will be posted periodically to the credit of a Goods on Approval Total Account.

(*b*) When goods are returned, they are entered in the Returns column in the Sold and Returned Day Book and posted to the credit of the customer's account in the Goods on Approval Ledger. The Returns column total will be posted periodically to the debit of Goods on Approval Total Account.

(*c*) When goods are retained, they are entered in the Sales column in the Sold and Returned Day Book. This column is provided with two folio columns, one for the posting to the credit of the customer's account in the Goods on Approval Ledger and the other for the posting of the same amount to the debit of his account in the ordinary Sales Ledger. The Sales column total will be posted to the Debit of Goods on Approval Total Account *and* to the credit of ordinary Sales Account.

When accounts are prepared, NO goods on approval figures will appear therein, since the total of the balances of customers' accounts in the Goods on Approval Ledger should equal the balance of the Goods on Approval Total Account. The value of goods on approval in the hands of customers *at selling price* can be ascertained either in detail from the Ledger or in total from the Total Account. This value, reduced to cost or lower market value, will be included in the Trading Account and Balance Sheet as before.

(3) Where such transactions are not sufficiently rare to deal with as in (1) and not sufficiently frequent to deal with as in (2), to employ a Goods on Approval Journal.

The procedure is—

(*a*) To enter the amount of goods delivered into a memorandum column.

(*b*) If the goods are returned, to enter the amount of goods returned into a memorandum column on the same line as the original entry for the goods delivered.

(*c*) If the goods are sold, to enter the amount of goods sold into the Sales column on the same line as the original entry for the goods delivered.

All the above entries will be at selling price.

At any time the total shown in the first column, less the total of the second and third columns, will equal the goods out on approval at selling price. This balance, when accounts are to be prepared, will be brought into the accounts at cost or market value whichever is the lower.

The third column is a "Double Entry" column and performs the same functions as an ordinary Sales Day Book.

Illustration. X sends goods out on appro. as follows—

19..		£	19..
Jan. 15	Y	31	Jan. 17 returned £25, retained £6.
18	R	18	21 all retained.
21	Q	9	23 all retained.
30	Y	40	No intimation received as to sale and goods not yet returned.
31	L	17	do.

Show how these transactions will be dealt with under Methods (2) and (3) above.

Method (2)

GOODS SENT ON APPROVAL DAY BOOK

19..	Particulars	Folio		£
Jan. 15	Y	G.o A.L.	1	31
18	R		2	18
21	Q		3	9
30	Y . .		1	40
31	L . . .		4	17
				£115

Goods on Approval Sold and Returned Day Book

	Particulars	G.o.A.L. Fol.	Returned	G.o.A.L. Fol.	S.L. Fol.	Sold
19..			£			£
Jan. 17	Y . .	1	25	1	?[1]	6
21	R . .			2	?[1]	18
23	Q . .			3	?[1]	9
			£25			£33[2]

Dr. **Goods on Approval Total Account** Cr.

19..			£	19..			£
Jan. 31	To Returns . . .		25	Jan. 31	By Goods sent out on Approval . .		115
	„ Sales . . .		33				
	„ Balance . . .	c/d	57				
			£115				£115
				Feb. 1	By Balance . . .	b/d	57[3]

Goods on Approval Ledger

Dr. **Y** Cr.

19..			£	19..			£
Jan. 15	To Goods . . .		31	Jan. 17	By Returns . . .		25
30	„ Goods . . .		40		„ Sales . . .		6
				31	„ Balance . . .	c/d	40
			£71				£71
Feb. 1	To Balance . . .	b/d	40[3]				

Dr. **R** Cr.

19..			£	19..			£
Jan. 18	To Goods . . .		18	Jan. 21	By Sales . . .		18

Dr. **Q** Cr.

19..			£	19..			£
Jan. 21	To Goods . . .		9	Jan. 23	By Sales . . .		9

Dr. **L** Cr.

19..			£				
Jan. 31	To Goods . . .		17[3]				

[1] Posted to the customer's account in the ordinary Sales Ledger.

[2] Posted to the credit of the ordinary Sales Account, as well as to the debit of Goods on Approval Total Account.

[3] The credit balance of £57 on Goods on Approval Total Account equals the debit balances in the Goods on Approval Ledger on the accounts of Y (£40) and L (£17). No balance on the special Goods on Approval books will appear in the ordinary Trial Balance on 31st January, 19... These books are outside the ordinary double entry book-keeping.

Method (3)

GOODS ON APPROVAL JOURNAL

Deliveries			Returns			Sales				
Date	Particulars	Amount	Date	Particulars	Amount	Date	Particulars	Fol.	Amount	Remarks
19..		£	19..		£	19..			£	
Jan. 15	Y . .	31	Jan. 17		25	Jan. 17		?[1]	6	
18	R . .	18				21		?[1]	18	
21	Q . .	9				23		?[1]	9	
30	Y . .	40	31	Balance c/d .	40					
31	L . .	17		Balance c/d .	17					
		£115			£82				£33[2]	
Feb. 1	Balance Y b/d	40[3]								
	Balance L b/d	17[3]								

[1] Posted to the debit of the customer's account in the ordinary Sales Ledger.
[2] Posted to the credit of Sales Account.
[3] The Deliveries and Returns columns are memorandum only, no postings being made therefrom. The total of the Returns (£25) and Sales (£33) columns deducted from the Deliveries column (£115) gives the value (at selling price) of the goods on approval still outstanding = £57.

In order to avoid the work entailed in carrying down a considerable number of balances when the books are balanced and closed off, the Goods on Approval Journal may be provided with extra columns so that the uncleared entries of one period may be cleared in the next period on the same line as the original entry. This form of Journal will be as follows—

GOODS ON APPROVAL JOURNAL

Period ending				Period ending					
Deliveries	Returns	Sales	Balance	Returns			Sales		
			..........[1]	Date	Particulars	Amount	Date	Particulars	Amount
as in the illustration on page 217									

It is unlikely that any items would remain open at the end of the second period. If there were any, the balances would be carried down as in the previous illustration.

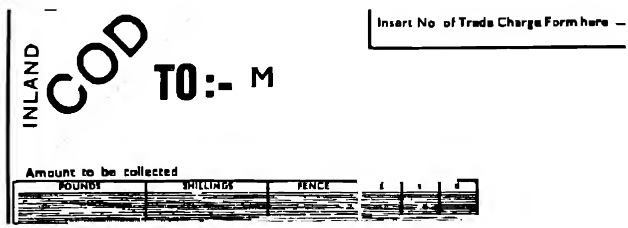
[1] Closing date of first period. The total of this column gives the amount of goods outstanding at the balancing date.

C.O.D.

The Cash on Delivery system plays a large part in the transaction of business in many concerns. By this system the Post Office, against delivery to the consignee, collects the cash for the goods and remits it to the sender.

The procedure for sending goods C.O.D. is as follows—

(1) A special adhesive address label supplied free by the Post Office is used on the parcel, viz.—


INLAND COD TO:- M

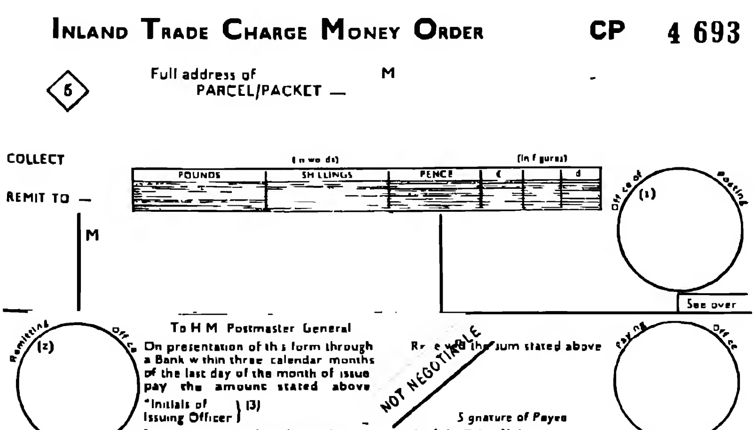
Insert No of Trade Charge Form here —

Amount to be collected

POUNDS	SHILLINGS	PENCE	£	s	d

(2) The parcel is handed in to the Post Office together with a duly completed Trade Charge Form. This form is in two parts, viz.—

(a)


INLAND TRADE CHARGE MONEY ORDER CP 4 693

6

Full address of PARCEL/PACKET — M

COLLECT (in words) (in figures)

POUNDS	SHILLINGS	PENCE	£	s	d

REMIT TO — M

Office of Posting (1)

See over

Remittance Office (2)

To H M Postmaster General
On presentation of this form through a Bank within three calendar months of the last day of the month of issue pay the amount stated above
*Initials of Issuing Officer (3)

NOT NEGOTIABLE

Received the sum stated above

Signature of Payee

Paying Office

* See paragraph II of the Instructions on the back of the Debit Note

(*b*)

DEBIT NOTE **CP 4 693**

5

Full address of PARCEL/PACKET — M

Amount to be collected	(In words) POUNDS	SHILLINGS	PENCE	(In figures) £	s	d

Office of Posting (4)

Sender of Parcel — M

NOT TO BE SENT TO PAYEE

(6) C O D stamps to be affixed here

FOR OFFICIAL USE

After the despatch of the Trade Charge Order to the sender date stamp this Debit Note in space (5) and enclose it with the Money Order Schedule in which it is debited

Remitting Office (5)

Stamps to cover the C.O.D. fee are affixed in the space allotted on the Debit Note (*b*)

(3) When the goods have been delivered against payment, the Money Order (*a*) is returned to the sender who may cash it through his Bank.

(4) Parcels should, where necessary, be registered in the usual way.

(5) The amount to be collected should, where desired, include the C.O.D. fees and postage as well as the price of the goods.

(6) A Posting Certificate Book should be kept which will be stamped by the Post Office when parcels are handed in to them for delivery.

(7) If the goods are refused by the consignee, the parcel is returned to the sender by the Post Office.

The book-keeping system for dealing with C.O.D. transactions will depend upon their value and number in each particular concern. The following may be given as a basis, to be amended where necessary to suit the particular circumstances.

(1) A C.O.D. Day Book should be kept with columns for—

(*a*) Date of despatch,
(*b*) Name and address of consignee,
(*c*) Description of goods,
(*d*) Price of goods per invoice,
(*e*) Postage,
(*f*) C.O.D. fees,
(*g*) Total amount due from consignee per Trade Charge Form,
(*h*) Trade Charge Form serial number,
(*i*) Date cash received,

(j) Goods returned,
(k) Postage and fees on returns (where included in the charge),
(l) Remarks,
and columns for reference to invoices, folios, etc., as desired.

(2) Receipts from Trade Charge Money Orders should be entered in a C.O.D. Cash Received Book, the total of which is entered periodically in the Main Cash Book.

(3) A C.O.D. Total Account should be kept.

(4) Postings will be as follows—

(i) Day Book
Column (d) Dr. C.O.D. Total Account Cr. Sales
(e) (1) if charged to customer—
Dr. C.O.D. Total Account Cr. Cash
(2) if not so charged—
Dr. Postages Cr. Cash
(f) as for column (e)
(j) Dr. Sales Cr. C.O.D. Total Account
(k) Dr. Postages Cr. C.O.D. Total Account
(ii) Cash Received Book
Dr. Cash Cr. C.O.D. Total Account

(5) The balance on C.O.D. Total Account will show the amount of Trade Charges outstanding. Suitable provision should be made, when accounts are prepared, for damages in transit (unless covered by insurance) and goods refused.

Illustration. A sends out the following goods C.O.D. during the month of January—

		Price	Postage	C O D Fees	Cash Received	Goods Returned
		£	s. d	s d.		
Jan 2	X . .	5	1 6	1 2	Jan. 6	
9	Y .	4	1 0	1 2	15	
11	P . .	10	2 6	1 4		Jan. 18
20	Q . .	3	1 3	1 2	27	
30	Z . .	8	9	1 4	Outstanding	

A charges both postage and C.O.D. fees to his customers. Show how these transactions would be dealt with in A's books. See page 222.

C.O.D. purchases. These will be dealt with in the same way as ordinary purchases through the Petty Cash Book or through a C.O.D. Payments Book. A strict system of internal check is imperative in order to avoid fraud, but this is outside the scope of this book.

C.O.D. Day Book

Date	Name, etc.	Description of Goods	Invoice Price	Postage	C.O.D. Fees	Total per TCF	TCF Serial No.	Date Cash Received	Goods Returned	Postage & Fees on Returns	Remarks
19..			£	s. d.	s. d.	£ s. d.			£	s. d.	
Jan. 2	X . .		5	1 6	1 2	5 2 8		Jan 6			
9	Y . .		4	1 0	1 2	4 2 2		15			
11	P . .		10	2 6	1 4	10 3 10			10	3 10	
20	Q . .		3	1 3	1 2	3 2 5		27			
30	Z . .		8	9	1 4	8 2 1					c/d
			£30	7 0	6 2	£30 13 2			£10	3 10	
Feb. 1	Z . .	b/d[1]	8	9	1 4	8 2 1					

Cash Received Book

		£ s. d.
Jan. 6.	K	5 2 8
15.	Y	4 2 2
27.	Q	3 2 5
		£12 7 3

[1] The balance brought down against Z has already been debited to C.O.D. Total Account in the January total. It is, therefore, ruled off in order to prevent its being included in the February total as well. Alternatively, the Day Book could be provided with extra columns for dealing with outstanding items, as shown previously in relation to Goods on Approval.

Dr. C.O.D. TOTAL ACCOUNT Cr.

		£	s.	d.			£	s.	d.
19.. Jan. 31	To Sales .	30	0	0	19.. Jan. 31	By Cash .	12	7	3
	" Cash (Postages) .		7	0		" Returns .	10	0	0
	" Cash (C.O.D. Fees) .		6	2		" Postages .		3	10
						" Balance c/d .	8	2	1
		£30	13	2			£30	13	2
Feb. 1	To Balance b/d	8	2	1					

VOYAGE ACCOUNTS

It is a practice among shipowners to ascertain the results of *each* voyage of a chartered ship separately. To do this a Voyage Account is prepared, which is merely a Profit and Loss Account covering the period of the particular voyage. For this purpose the "voyage" is taken as the outward and return journeys of the vessel.

The preparation of the Voyage Account should present no difficulty as it is essentially a Profit and Loss Account. The following points, however, peculiar to Voyage Accounts, should be noticed.

(1) *Brokerage and Commission.* In addition to the Port charges, duties, harbour wages, and other expenses on the voyage, a brokerage to the charterers' agent is usually paid, and frequently an "address" commission to the charterers themselves, both these commissions being computed on freights *earned.* Frequently the managers may be entitled to a commission on freights earned.

(2) *Insurance.* The charges against the voyage must be exactly applicable to the particular voyage, e.g. a ship may be insured for a whole year, but the amount chargeable against the voyage must be such portion as is applicable to the duration thereof.

(3) *Stores.* Similarly, a stock of stores may be bought for use during the voyage, and on the ship's return the stores on hand must be brought into account.

(4) *Depreciation.* Such items as depreciation on ship and tackle, repairs, renewals and replacements thereof, must be charged in order to ascertain the true results of each voyage.

(5) *Passengers.* The freights earned may be supplemented by passage moneys in respect of passengers carried.

(6) *Shares of Ships.* Every British ship is divided into 64 shares and each share may be owned by not more than five persons.

Illustration. The steamship *Travancore* was chartered on 29th September, 19.., to carry tin from Southampton to Lisbon at 15s. per ton, and on the return journey to carry wine from Lisbon to Liverpool at 30s. per dozen casks. The vessel was insured on 25th March, 19.., for a year in advance, premium being £1,200. From the following particulars prepare Voyage Account, the vessel arriving in Liverpool on 31st October, 19...

Freight carried, 1,200 tons of tin to Lisbon and 800 dozen casks of wine from Lisbon.

Sundry disbursements for voyage (including port charges, harbour wages, coal, captain's expenses, etc.), £1,217. Stores bought, £132. (*N.B.* Stock in hand 29th September, £52; 31st October, £64.)

Address Commission 2 per cent on freight earned on outward journey; 3 per cent on freight earned on inward journey.

Brokerage of 4 per cent to charterers on freight earnings for whole voyage. Managers to receive 5 per cent on net profits after charging such commission.

Passage money from passengers amounted to £112 on the outward journey and £98 on the inward.

The written down value of the ship and tackle is £25,200. Depreciation is to be provided at 10 per cent per annum (calculate in months).

Before distributing the profit the sum of £180 is put to Reserve.

S.S. "TRAVANCORE"

Voyage No. ——. 29th September, 19.., to 31st October, 19..

		£			£
To Sundry Disbursements (port charges, coal, wages, etc.)		1,217	By Freights earned—		
,, Stores (52 + 132 − 64)		120	1,200 tons of tin at 15s. to LISBON		900
,, Address Commission—			800 doz. casks of wine at 30s. to LIVERPOOL		1,200
Outward 2 per cent on £900		18	,, Passage Money—		
Inward 3 per cent on £1,200		36	Outward		112
,, Brokerage 4 per cent on £2,100		84	Inward		98
,, Insurance $\frac{1}{12}$ of £1,200		100			
,, Depreciation (1 month)		210			
,, Balance	c/d	525			
		£2,310			£2,310
To Managers' Commission (5 per cent on £500)		25	By Balance	b/d	525
,, Reserve		180			
,, Net Profit (divisible as to £5 per share)		320			
		£525			£525

PURCHASE TAX

A full explanation of the working of Purchase Tax would be out of place in this book, but the following summary is given in order that the book-keeping entries required may be the better understood.

(1) Purchase Tax applies to a wide range of goods and came into operation on 21st October, 1940. It is administered by the Commissioners of Customs and Excise.

(2) The tax is charged at varying rates and the rate applicable to particular classes of goods may be changed from time to time. Three rates were laid down by the Finance Act, 1948, viz. $33\frac{1}{3}$, $66\frac{2}{3}$, and 100 per cent, and two intermediate rates were introduced by the Finance Act, 1952, viz. 25 and 50 per cent. Some goods are exempt.

(3) The tax is charged when goods pass from a *registered* trader (usually the wholesaler) to an *unregistered* trader (usually the retailer). In most cases the wholesale price is the value on which the tax is charged. Delivery charges to the buyer's premises, if not already in the price, must be added when calculating the tax value.

(4) The tax is payable in such cases by the registered trader, who is entitled to increase the price so as to include the tax, which must be shown separately on the invoice.

(5) Apart from being liable on the sale of chargeable goods to an unregistered person, the registered trader is liable for tax on chargeable goods transferred to a separate retail branch or section of his own business or appropriated to other purposes, e.g. private use.

(6) Registered traders are not liable for tax on sales to other registered traders, nor to overseas buyers, nor to certain government departments.

(7) Returns are required by the Commissioners in respect of each calendar quarter's trading. Such returns must be made—and the tax paid—within one month of the end of each quarter.

(8) The following concessions are allowable, usually subject to confirmation—

(*a*) Small quantities of free trade samples.

(*b*) Bad Debts in certain cases.

(*c*) Returns, and Allowances for defectives and losses in transit.

(*d*) Cash discounts available to buyers generally, the tax being charged on the net cash price (but, of course, no discount can be allowed on the tax itself).

These concessions, however, apply only to registered dealers. Once the goods have passed to an unregistered person, the tax becomes merged in the price. Applications for relief in respect of Bad Debts may only be made by registered persons and no abatement of tax is allowable for loss or damage to goods in retail stock.

(9) In the event of the bankruptcy or liquidation of a registered person, Purchase Tax is a preferential debt (*vide* Finance Act, 1942, Section 20, and Companies Act, 1948, Section 319), if due up to twelve months prior to the Receiving Order (in Bankruptcy) or the commencement of the liquidation which will be the date of the resolution in Voluntary Liquidation or the date of the Court order or appointment of provisional liquidator in Compulsory Liquidation; or where there is a Receiver for Debenture Holders by way of floating charge the date of appointment of the Receiver, or where Debenture Holders take possession the date of taking possession.

Accounting entries. All registered persons are required to keep such records of their dealings in chargeable goods as will enable them to compute the proper tax chargeable and to pay such tax to the Commissioners at the due time. The actual records must vary with and be adapted to suit the requirements of each particular concern. They must, however, show, in regard to purchases, whether the goods were received tax-free under a registered number or tax-paid

and, in regard to sales, whether the goods were sold tax-free for export or to other registered traders, etc., or tax-paid. Where there are internal transfers of goods during manufacture or as mentioned in (5) above, special records will be required.

In regard to ordinary tax-inclusive sales and purchases, the following procedure is recommended—

(1) Sales by registered trader (e.g. wholesaler) to unregistered trader (e.g. retailer).

(*a*) Separate columns should be provided for Purchase Tax in the Sales Day Book, Returns Inwards Book and, if desired, in the personal accounts in the Sales Ledger.

(*b*) A Purchase Tax Account should be opened in the Nominal Ledger.

(*c*) The ordinary sale price will be dealt with throughout in the usual way. The Purchase Tax on each sale will be entered in the special column in the Day Book, the amount agreeing with the tax shown on the invoice, and will be posted to the (special column on the) debit side of the customer's account. Credits for returns, etc., will, *mutatis mutandis*, be dealt with similarly.

(*d*) The total of the Purchase Tax columns in the Day Book and Returns Book will be posted periodically (e.g. monthly, but certainly at the end of each calendar quarter so that the necessary returns may be prepared) to the credit and debit respectively of the Purchase Tax Account. This latter account will be debited, and Bank (or Cash) credited, when payment is made to the Commissioners.

(*e*) Receipts from customers will be entered in the Cash Book and posted to the credit of the respective accounts in the Sales Ledger in the usual way.

(*f*) When Bad Debts are written off, assuming that the wholesaler is allowed to write off the tax owing, the balance of the Purchase Tax in the customer's account will be transferred to the debit of Purchase Tax Account, thus reducing the amount payable to the Commissioners.

(*g*) For Balance Sheet purposes, Sundry Debtors' balances extracted from the Sales Ledger will consist of two parts—(*a*) goods and (*b*) tax. The balance of Purchase Tax Account, being the amount owing to the Commissioners, will appear as a liability.

(2) Purchases and Sales by unregistered trader[1] (e.g. retailer).

(*a*) Separate columns should be provided as in (1) above.

(*b*) The total of the Purchase Tax column in the Purchases Day Book will be posted periodically to the debit of Purchase Tax Account, and vice versa in respect of Returns.

(*c*) The tax column total in the Sales Day Book and the purchase tax on cash sales, will be credited to Purchase Tax Account.

[1] The retailer is not bound by law to keep separate records of Purchase Tax, but some do so to enable them to check the true gross profit earned.

(*d*) The balance of the Purchase Tax Account at the end of the accounting period should equal the tax on stock in hand and will be carried down by crediting Purchase Tax Account "above the line" and debiting it "below the line." The balance will appear on the Asset side of the Balance Sheet as a subheading of Stock.

(*e*) Alternatively, when circumstances do not permit the apportionment of Cash Sales Receipts between tax and ordinary sale price, the following procedure may be adopted—at the end of the accounting period when stock is taken, the stock sheets will show in a separate column the amount of tax on the stock. This figure will be credited to Purchase Tax Account as before and carried down. The balance on Purchase Tax Account will now be transferred to the debit of Cash Sales Account, to which the gross receipts have been credited. The balance of Cash Sales Account will be transferred to Trading Account.

Illustration. Show how, as regards Purchase Tax, the following transactions would appear in the books of a wholesaler who is registered for Purchase Tax purposes—

	Sales	Tax
	£	£
Sales Day Book Totals	30,000	12,000
Returns Inwards Book Totals	6,000	1,000
Opening Debtors	7,000	2,000
Closing Debtors	9,000	3,000
Cash received from Debtors	20,000	9,800
Discounts Allowed	1,000	
Bad Debts	1,000	200
Purchase Tax owing to Commissioners—		
At beginning		4,000
At end		3,800
Purchase Tax paid during period		11,000

Dr. SUNDRY DEBTORS *Cr.*

	P. Tax	Sales		P. Tax	Sales
	£	£		£	£
To Balances b/d	2,000	7,000	By Returns	1,000	6,000
,, Sales	12,000	30,000	,, Cash & Disct.	9,800	21,000
			,, Bad Debts		1,000
			,, Purchase Tax Account	200	
			,, Balances c/d	3,000	9,000
	£14,000	£37,000		£14,000	£37,000
To Balances b/d	3,000	9,000			

Dr. PURCHASE TAX Cr.

	£		£
To Returns	1,000	By Balance b/d	4,000
,, Bad Debts	200	,, Sales	12,000
,, Cash	11,000		
,, Balance c/d	3,800		
	£16,000		£16,000
		By Balance b/d	3,800

Illustration. The following figures are from the books of X, a retailer not registered for Purchase Tax purposes, at the end of his first year of business. Show how they would appear in his final accounts. X wishes to keep separate records of Purchase Tax.

	Gross	*Purchase Tax*	*Net*
	£	£	£
Purchases	1,730	460	1,270
Sales (all cash)	1,810	—	—
Closing Stock	217	60	157

Dr. TRADING ACCOUNT (includes) Cr.

	£		£
To Purchases	1,270	By Sales	1,410
		,, Stock	157

BALANCE SHEET (includes)

		£	£
	Stock at cost	157	
	Purchase Tax	60	217

The rough accounts will be—

Dr. PURCHASES Cr.

	£		£
To Sundries	£1,270	By Trading Account	£1,270

Dr. SALES Cr.

	£		£
To Purchase Tax	400	By Cash	1,810
,, Trading Account	1,410		
	£1,810		£1,810

Dr.	Purchase Tax		Cr.
	£		£
To Sundries . . .	460	By Balance c/d . . .	60
		„ Sales	400
	£460		£460
To Balance b/d . .	60		

P. A. Y. E.

The system of collecting Income Tax from employees known as Pay As You Earn or P.A.Y.E. has been in force since the beginning of the year 1944/45. Under this system the employer must deduct from wages paid the amount of Income Tax found by reference to the official Tax Tables applicable to the code number allotted to each employee, the code number being based on the allowances to which the employee is entitled.

The deductions, which are made weekly or monthly according, in general terms, to whether the basis of payment of remuneration is by reference to the week or month, are provisional only, in the sense that (*a*) they are based on moneys payable and not necessarily on earnings, and (*b*) the coding only approximates to the allowances available. After the end of the tax year, the Revenue will issue a notice of assessment based on earnings and allowances, showing the tax liability against which will be set off the total tax deducted during that year. The latter should agree with the sum shown on the official tax deduction card which is kept by the employer for each employee and also on the certificate of tax deducted, issued to each employee at the end of the tax year.

It may be noted that the employer is not concerned with the accuracy of the code number: his task is to make the tax deductions in accordance with the code numbers given to him in respect of each employee by the Inland Revenue.

Accounting entries. There is no set method of accounting for P.A.Y.E. provided that the wages and the tax deductions (less refunds, if any) are clearly shown and that the latter are fully accounted for and agree with the sums shown on the Tax Deduction cards. The basic entries are—

Debit Wages with the gross amount
Credit Cash with the net wages paid.
Credit P.A.Y.E. (or C.I.R.) with the tax deducted.

When the tax deducted is handed over to the Inland Revenue, the entries will be—

Debit P.A.Y.E. (or C.I.R.).
Credit Cash.

The exact manner of carrying out these entries will depend upon

the circumstances in each case; there are many methods in use, two of which are—

(1) On the credit side of the Cash Book are entered net wages paid and, in a special column, tax deducted. The two entries are together posted to the debit of Wages and/or Salaries. The monthly total of the Tax deducted column is posted to the credit of P.A.Y.E. Account.

(2) The gross wages are debited to Wages and/or Salaries and credited to Cash. Tax deducted is debited to Cash and credited to P.A.Y.E. Account as before.

The Wages Book (in addition to the usual columns for N.I. and other deductions) will be ruled with two columns, one for tax deductions, the other for tax refunds. The wages and tax figures will either be summarized in a separate book or carried forward cumulatively, week by week, up to the last pay day before the 6th of April of each year. These summarized or cumulative figures should agree with the tax deduction/refund figures on the employees' cards, subject to adjustment for employees who have left during the year, and, in the case of new employees during the year, subject to the amounts introduced on to the cards (in respect of the previous employment) in accordance with the notification by the Inland Revenue.

Illustration. Assuming that A employs three assistants, B, C, and D with weekly wages of £3, £4 and £6, respectively, the tax deductions being—

	1st Week	*2nd Week*	*3rd Week*
B	1/–	2/–	1/–
C	2/–	*Refund* 1/–	3/–
D	6/–	6/–	5/–

show the entries in the Wages Book.

					Cumulative Figures			
	Gross Wages	Tax Deducted	Tax Refunded	Net	Gross Wages	Tax Deducted	Tax Refunded	Net
	£	s.	s.	£ s. d.	£	£ s. d.	s.	£ s. d.
1st Week								
B . .	3	1	—	2 19 0	—	—	—	—
C . .	4	2	—	3 18 0	—	—	—	—
D . .	6	6	—	5 14 0	—	—	—	—
	£13	9	—	£12 11 0				
2nd Week								
B .	3	2	—	2 18 0	6	3 0	—	5 17 0
C .	4	—	1	4 1 0	8	2 0	1	7 19 0
D . .	6	6	—	5 14 0	12	12 0	—	11 8 0
	£13	8	1	£12 13 0	£26	17 0	1	£25 4 0
3rd Week								
B . .	3	1	—	2 19 0	9	4 0	—	8 16 0
C . .	4	3	—	3 17 0	12	5 0	1	11 16 0
D . .	6	5	—	5 15 0	18	17 0	—	17 3 0
	£13	9	—	£12 11 0	£39	£1 6 0	1	£37 15 0

There are many wages sheets specially printed to economize space and writing.

To ascertain the tax to be deducted or refunded each week, reference must be made to the appropriate week in the Tax Tables which will show the total tax payable on the total wages from the first week in the tax year (e.g. 6th April to 12th April) to the week in question, so that the tax deduction (or refund) will be the amount shown in the Table less the net total of tax deducted to date, or plus the net total of refunds.

Where the payments are monthly the card is built up monthly (e.g. 6th April to 5th May) instead of weekly.

In consequence of the operation of P.A.Y.E. a "free of tax" salary to an employee must be "grossed" for the purpose of entering in the pay card and accounting to the Inland Revenue for the tax deducted on the notional gross remuneration.

Illustration. X is employed at a salary of £900 per annum, free of income tax, payable quarterly on 1st April, etc. The tax for this purpose is that payable on the gross salary after deducting all allowances to which the employee is entitled, except that these are to be reduced by any other income to which the employee may be entitled. (In other words, he will bear Income Tax on his private income at the Standard rate.) X has untaxed Interest £159, and the net annual value of his residence is £22. He is married with two children under 16.

Show the gross income, tax deductions, and tax liability for 1953–54.

The income to be set off against his personal allowances is—

	£	£
N.A.V.		22
Untaxed Interest		159
Family Allowance (1 child)[1]	21	
Less $\frac{2}{9}$ Earned Income Allowance	5	
		16
		£197

The allowances to which X is entitled (in addition to Earned Income Allowance) are—

	£
Personal Allowance	210
Children	170
National Insurance Contributions	9
	£389

	£
The net allowances to be placed against salary	389
Less set off against other income	197
	£192

The gross salary is therefore £900 plus the Income Tax liability

[1] 8s. per week for the second child.

thereon, after allowing deductions of £192 plus Earned Income Allowance. The Income Tax calculation is shown below, T standing for Tax.

$$T = 102\tfrac{1}{2}\,^{1} + \frac{9}{20}\left\{\frac{7}{9}(900 + T) - 192 - 400\right\}$$

$$= 102\tfrac{1}{2} + \frac{9}{20}\left\{\left(\frac{6{,}300 + 7T}{9}\right) - 592\right\}$$

$$= 102\tfrac{1}{2} + \frac{9}{20}\left(\frac{6{,}300 + 7T - 5{,}328}{9}\right)$$

$$9T = 922\tfrac{1}{2} + \frac{9}{20}(7T + 972)$$

$$180T = 18{,}450 + 63T + 8{,}748$$

$$117T = 27{,}198$$

$$\therefore\ T = \underline{\underline{£233}}\ \text{(to nearest £)}$$

Hence the gross remuneration is £900 + £233 = £1,133 to nearest £.

The tax liability will rarely work out exactly because the assessments are made on the basis of the nearest £, the Earned Income allowance being also to the nearest £ or 10s. As regards the tax deductions, these are not exact because the codings are based on "ranges" of allowances, e.g. for 1953–54 where the personal allowances are between 190 and 192, the coding is the same [56] so that if the personal allowances are actually lower than the top figure (in this instance lower than 192) there will be an under-deduction; and as the tax deductions in the Tax Tables are also in "ranges" and not shown for exact remuneration, the latter, if falling between two amounts, must be taken on the smaller, which will result in an under-payment. These under- or over-payments will be adjusted after the end of the tax year, in the event of an over-deduction, either by repayment at the request of the taxpayer or by amending the coding for the year but one following if the taxpayer does not claim repayment, and in case of an under-deduction, by payment of the balance if required by the Inspector or by adjustment of the coding in the year but one following as above. The tax deductible in the Tables is given to the nearest shilling, but this will not cause a cumulative difference between the exact tax and the Table tax, as an under- or over-deduction arising from this cause will be automatically remedied in subsequent weeks or months.

[1] As the tax on the first £400 of taxable income is £102 10s, the calculation shows this to be £102½, and £400 is deducted in arriving at the remaining tax.

X's Income Tax position is—

		Total		*Set-off*		*Employment*
		£	£	£	£	£
Salary		1,133		—		1,133
Family Allowance		21		21		—
Untaxed Interest		159		159		—
N.A.V.		22		22		—
		1,335		202		1,133
Less—						
Earned Income Allowance—						
$\frac{2}{9}$ × £1,154	256		5		251	
National Insurance	9		9		—	
Personal Allowance	210		188		22	
Children's Allowance	170		—		170	
		645		202		443
		£690		*Nil*		£690

Tax payable—	£ s. d.
£100 at 2s. 6d.	12 10 0
£150 at 5s.	37 10 0
£150 at 7s.	52 10 0
£290 at 9s.	130 10 0
£690	£233 0 0

The code number will be found by reference to the official schedule on the basis of allowances of £192, not £443, as the coding gives effect to the Earned Income Allowance, i.e. Code 56.

The pay card will be as follows (in essential detail only)—

	Gross Pay for Quarter	Gross Pay to Date	Free Pay to Date	Total Taxable Pay to Date	Total Tax Due to Date	Tax Deducted
	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.
1953						
July 1	283 5 0	283 5 0	61 16 0	221 9 0	57 19 0	57 19 0
Oct. 1	283 5 0	566 10 0	123 12 0	412 18 0	115 19 0	58 0 0
1954						
Jan. 1	283 5 0	849 15 0	185 8 0	664 7 0	174 5 0	58 6 0
Apr. 1	283 5 0	1,133 0 0	247 4 0	885 16 0	231 18 0	57 13 0

The tax deducted £231 18s. as against the true liability of £233 shown in the assessment represents an underpayment which will be adjusted as already described. (In practice, small underpayments are usually ignored by the Inland Revenue.)

CHAPTER X

SELF-BALANCING LEDGERS AND SECTIONAL BALANCING

WHERE numerous Ledgers are utilized by a concern it will naturally follow that it may be of the utmost difficulty to trace book-keeping errors which disturb the agreement of the Trial Balance and consequently impede the construction of the Final Accounts. In order to reduce to a minimum the trouble of, or the time involved in, the localization of errors, the system of Self-balancing Ledgers, or Sectional Balancing, is employed.

The two terms are often employed synonymously, but strictly the former applies to one method only (see footnote page 237).

The advantages of Sectional Balancing are—

(1) It provides a proof of the total arithmetical accuracy of the book-keeping entries in any Ledger. It must be appreciated, however, that the proof of a Ledger by means of sectional balancing provides only such proof of its accuracy as does the Trial Balance of the accuracy of the complete set of books. Thus, compensating errors, postings to the correct side of the Ledger but to wrong accounts, and errors in the books of original entry continued through the Ledgers, will not be disclosed.

(2) In conjunction with other precautionary measures employed in a system of internal check, it may serve as a check on the honesty of the Ledger-keepers.

(3) It is of material assistance in the location of errors which, causing the books to be out of balance, may impede the preparation of the Final Accounts and may take a considerable amount of time to discover, particularly where there are many Ledgers in use, as the Ledger in which the error is located may not be checked until all the others have been scrutinized.

(4) The preparation of draft annual or periodical accounts pending the extraction of the schedules of debtors and creditors may be proceeded with.

The Construction of Total or Adjustment Accounts. The systems designated by these titles are extremely simple in principle, though it must be admitted that care and patience are demanded where there are numerous Ledgers in use.

A total account is a replica in summarized form of all the detailed entries in the Ledger to which it refers. The balance of such Account should be similar to the total of the detailed balances of the Ledger. Should the balance of the Total Account not agree with the total of the individual balances in the Ledger, it will be known that a mistake has been made in the compilation of the Total Account or

that errors have been made in the casting of books of original entry or in the posting of the individual items to the Ledger.

The practice of Sectional Balancing is generally confined to the Purchases and Sales Ledgers although theoretically the principle may be extended to all the Ledgers.

Analysis of Subsidiary Books. It is essential, where it is desired to construct Total Accounts, that every entry in the Ledger shall have a complementary entry in some book of original entry which is capable of analysis. The way in which the subsidiary books are analysed will depend upon the number of Ledgers in use and the number of entries to be posted to each Ledger in each particular concern. Obviously, the system must be adapted to fit particular needs.

In cases where there are few Ledgers in use, each subsidiary book will have columns for the different Ledgers so that an amount posted to a particular Ledger will be inserted in the appropriate column. As a result, the total of the postings to a particular Ledger will be shown in total form in the column used for that purpose in each subsidiary book.

However, where the items posted to the Ledgers are few in number it may be considered unnecessary to have the subsidiary books specially ruled with analysis columns. Bold index letters may be written beside the folio number against each item, if necessary in different coloured inks for different Ledgers, and at the end of suitable periods all the individual items posted to different Ledgers may be summarized into their respective groups.

On the other hand, where the items to be posted are very numerous it may be advisable to employ completely *separate* books for each Ledger, thus dispensing with the analysis columns.

In the case of mechanized accounting, analysis is simplified by the fact that the required totals can be produced by the machine as the postings are made.

The individual subsidiary books will now be considered.

(*a*) **Cash Book.** Besides the usual three columns for Discount, Cash and Bank, it will be necessary to provide columns for the different Ledgers for which it is desired to prepare Total Accounts. The total amount of Cash plus Discount, or of Bank plus Discount, posted to individual accounts will be extended into the analysis columns.

Illustration. Cash has been received from the following customers—

I	£ 24,	discount	£1.	Sales	Ledger	A–L
E	£140,	,,	£3.	,,	,,	A–L
R	£ 45,	,,	£2.	,,	,,	M–Z
B	£ 71.	,,	£2.	,,	,,	A–L
S	£220,	,,	£6.	,,	,,	M–Z

There are two Sales Ledgers, A–L and M–Z.

The debit side of the Cash Book will be as follows—

		Discount	Cash	Bank	Ledgers	
					A–L	M–Z
		£	£	£	£	£
I . .		1	24		25	
E . .		3	140		143	
R . .		2	45			47
B . .		2	71		73	
S . .		6	220			226
		£14	£500		£241	£273

The total of the discount column will be dealt with in the ordinary manner, and the Cash will be balanced off as usual. The totals of the "A-L" Ledger column and of the "M-Z" Ledger column will be carried to the credit of the Adjustment (or Total) Accounts maintained for those Ledgers, in addition to the posting of the items to the credit of the individual personal accounts. Where it is not possible to have sufficient columns in the Cash Book itself, subsidiary Cash Received Books will be used, the totals of which will be entered periodically in the Main Cash Book and posted to the relative Total Accounts.

(*b*) **Day Books.** The Day Books (Purchases and Sales, Purchases Returns and Sales Returns, Allowances, etc.) will be analysed in a manner similar in principle to the Cash Book, viz. by the use of an extra column for each Ledger employed, or by the use of separate books for each Ledger or group of Ledgers.

(*c*) **Journal.** Items of an extraordinary nature which are recorded in none of the other books of original entry must be recorded in the Journal, which must be analysed just as the other books for the purpose of the preparation of Total Accounts. Items such as Bad Debts written off, Interest charged on accounts, and transfers from one Ledger to another must all be recorded in some book of original entry, and since they are not to be found in any other book, will be entered in the Journal.

Where transfers are of frequent occurrence, it is sometimes found that a special Transfer Journal is employed to record them, as great confusion is likely to arise where transfers are improperly recorded.

The Journal may be ruled with analysis columns, or may be analysed by the medium of index letters, etc.

Illustration. Robertson keeps three Sales and two Purchases Ledgers. Johnson both buys from and sells to Robertson, and it is agreed to set off a debt of £30 due by Johnson to Robertson against an amount owing by the latter to Johnson. Johnson's debit appears in Sales Ledger 3 and his credit in Purchases Ledger 2. Furthermore,

an amount of £40 has been credited to Williams in Sales Ledger 3 instead of to Williamson in Sales Ledger 2.

Show the Transfer Journal in Robertson's books in respect of these matters.

Robertson's Books—

TRANSFER JOURNAL

			Debits					Credits					
			Sales Ledger			Purchases Ledger		Sales Ledger			Purchases Ledger		
Date	Details	Fol.	1	2	3	1	2	1	2	3	1	2	Fol.
			£	£	£	£	£	£	£	£	£	£	
	Johnson—Set-off .						30			30			
	Williamson—Correcting entry posted to Williams in error . . .				40				40				

When the books are closed off the balances of the Total Accounts will be equal to the sum of the balances in the Ledgers to which they relate, provided that—

(1) Whatever entry is made in a Ledger finds its way to the correct side in the Total Account;

(2) Whatever entry is made in the Total Account of a Ledger has been correctly recorded in the Ledger itself.

Balancing Methods. There are three methods of dealing with Sectional Balancing—

(1) To prepare a Total Account for each Sales and Purchases Ledger by way of Memorandum only, serving to prove in total the separate balances in each Ledger. The Total Account includes the component items on the SAME side as in the Ledger to which it relates. Such a Total Account does not appear as an item in the Trial Balance.

(2) To prepare Total Accounts as an integral part of the Double Entry system, such accounts displacing in the Trial Balance the individual personal balances of the Ledgers to which they relate. The Total Account being the epitome of the Ledger to which it refers will include the component items on the SAME side as that on which the separate items appear in the Ledger.

(3) In order to incorporate in the Double Entry system both the balances of the Ledgers and the balances of the Total Accounts, two Total Accounts are prepared, the component items being exactly opposite.[1]

The Total Accounts will appear—

(*a*) At the back of each Ledger, the items being written up on

[1] The term "Self-balancing Ledgers" is particularly applied to this method.

the OPPOSITE side to the detailed entries in the personal accounts in the Ledger; and

(*b*) In the Nominal Ledger, the items being written up conversely to (*a*), i.e. on the SAME side as the detailed entries in the personal accounts in the Ledger.

Illustration. Assuming that sundry balances are: Debits, £1,200; Credits, £1,930; excepting Sales Ledger balances amounting to £730, the Trial Balance will be—

Methods.	1.		2.		3.	
	Dr.	*Cr.*	*Dr.*	*Cr.*	*Dr.*	*Cr.*
	£	£	£	£	£	£
Sundry Debits	1,200		1,200		1,200	
Sundry Credits		1,930		1,930		1,930
Sundry Debtors (per Sales Ledger) .	730		Not in Trial Balance		730 (*a*)	
Total Account in Nominal Ledger .	Memo. *not* in Trial Balance		730		730	
Total Account in Sales Ledger . .						730 (*b*)
	£1,930	£1,930	£1,930	£1,930	£2,660	£2,660

In method (3) the Sales Ledger is "Self-balancing" in that the credit of the Total Account (*b*) balances the total of the individual Ledger balances in that Ledger (*a*).

The headings employed are—

(*a*) Sales Ledger.

(i) At the back thereof. "Nominal Ledger Adjustment Account" (Balance Credit).

(ii) In the Nominal Ledger. "Sales Ledger Adjustment Account" (Balance Debit).

(*b*) Purchases Ledger.

(i) At the back thereof. "Nominal Ledger Adjustment Account" (Balance Debit).

(ii) In the Nominal Ledger. "Purchases Ledger Adjustment Account" (Balance Credit).

It will be seen that the totals extracted from the subsidiary books will in each method be posted to the same side of the Total Account as if posted to the individual Ledger Account—and to the reverse side also if Method (3) be adopted, e.g. assuming that receipts from Debtors are £1,420, the postings of that Total (from the analysis column in the Cash Book) will be—

(1) To "Sales Ledger Adjustment Account" in Nominal Ledger (CREDIT side).

(2) To "Nominal Ledger Adjustment Account" in Sales Ledger (DEBIT side).

In the absence of errors, the balance as shown by the Total or Adjustment Account should equal the sum of the individual balances of the Ledger in question, but occasionally debit balances

are found in the Purchases Ledger as well as credit balances; and credit balances in the Sales Ledger in addition to debit balances. The balance of the Total Account will then only equal the net balance of the Ledger. The usual practice is to bring down on the Total Account the totals of the debit balances and of the credit balances on the ledger to which it relates, but if the Trial Balance is prepared before the detailed balances of the Sales Ledgers are known, it is possible to bring down only the net balance of the Total Account. (The use of the reflective Total Accounts is extremely rare, and in fact the duplication of the Total Account in reverse is unnecessary.)

Illustration. Total Accounts are employed in the business of X in relation to the Sales Ledgers A and B. The following are the material details—

	A.	B.
	£	£
Opening Balances *Dr.*	1,250	3,100
Cr.	30	
Sales as per Sales Day Book	3,120	4,310
Returns as per Returns Day Book	317	205
Cash received as per Cash Book	2,005	5,120
Discounts allowed as per Cash Book	130	270
Bad Debts written off as per Journal	371	425
Provision for Bad Debts as per Journal	500	600
Bad Debts, previously written off, now received as per Cash Book	30	
Allowances as per Allowances Book	42	37
Bills Receivable as per Bill Book	130	
Bills dishonoured as per Cash Book	50	
Closing Credit Balances	72	21

The Transfer Journal contains a correcting entry in respect of £120 Sales which had been entered in error in the A Ledger analysis column in the Sales Day Book instead of in the B Ledger analysis column, although the item had been posted to the correct Ledger Account in B Ledger.

Prepare Total Accounts.

1. In the Nominal Ledger.

Dr. SALES LEDGER ADJUSTMENT ACCOUNTS *Cr.*

		A.	B.			A.	B.
		£	£			£	£
To Balances	b/d	1,250	3,100	By Balances	b/d	30	
,, Sales		3,120	4,310	,, Returns		317	205
,, Bills Receivable dishonoured		50		,, Cash and Discount		2,135	5,390
				,, Bad Debts		371	425
,, Transfers			120	,, Allowances		42	37
,, Balances	c/d	72	21	,, Bills Receivable		130	
				,, Transfers		120	
				,, Balances	c/d	1,347	1,494
		£4,492	£7,551			£4,492	£7,551
To Balances	b/d	1,347	1,494	By Balances	b/d	72	21

(2) At the back of the respective Sales Ledgers the above items will all be repeated on the reverse sides, e.g. in A Sales Ledger the

balances on the Nominal Ledger Adjustment Account will be: Debit £72, Credit £1,347.

Notes. (1) The Bad Debts Provision does not concern the individual Ledger balances and the respective Total Accounts.

(2) The receipt of Bad Debts written off is usually debited to Cash and credited direct to Bad Debts Received Account so that it does not affect the Total Account. Where, however, the receipt of such a Bad Debt written off is posted to a personal account the entries will be—

(*a*) *Dr.* Cash: *Cr.* Personal Account.
(*b*) *Dr.* Personal Account: *Cr.* Bad Debts.

There will then appear in the Total Account the Personal Account items, i.e the same amount on both sides: (*a*) from the analysis column in the Cash Book; (*b*) from the Transfer Journal.

An illustration of a Purchases Ledger Adjustment Account will now be shown.

Illustration—

	£
Opening Balances *Cr.*	6,000
Dr.	150
Purchases as per Purchases Day Book	9,000
Returns as per Returns Day Book	200
Cash paid as per Cash Book	8,700
Cash received as per Cash Book	50
Discounts received as per Cash Book	400
Allowances as per Allowances Book	130
Bills Payable as per Bills Payable Book	250
Closing Debit Balances	100
Transfers of Purchases to another Ledger	20

Prepare Total Accounts.

(1) In the Nominal Ledger.

Dr. PURCHASES LEDGER ADJUSTMENT ACCOUNT *Cr.*

		£			£
To Balances	b/d	150	By Balances	b/d	6,000
,, Cash and Discount		9,100	,, Purchases		9,000
,, Returns		200	,, Cash		50
,, Allowances		130	,, Balances	c/d	100
,, Bills Payable		250			
,, Transfers		20			
,, Balances	c/d	5,300			
		£15,150			£15,150
To Balances	b/d	100	By Balances	b/d	5,300

(2) At the back of the Purchases Ledger this account would appear in reverse form.

Dr. NOMINAL LEDGER ADJUSTMENT ACCOUNT *Cr.*

		£			£
T Balances	b/d	6,000	By Balances	b/d	150
,, Purchases		9,000	,, Cash and Discount		9,100
,, Cash		50	,, Returns		200
,, Balances	c/d	100	,, Allowances		130
			,, Bills Payable		250
			,, Transfers		20
			,, Balances	c/d	5,300
		£15,150			£15,150
To Balances	b/d	5,300	By Balances	b/d	100

Although method (3) is theoretically the most correct as far as making the Ledgers self-balancing is concerned, one of the total accounts is obviously superfluous since it is merely a duplication of the other. This method is therefore rarely employed in practice. The most effective practical method is for a responsible official to keep a separate book, containing a Total Account for each Ledger, which is not accessible to the various ledger clerks. The Total Accounts will then serve as a good check on the work of the clerks.

Other Uses of Total Accounts. The use of Total Accounts is not confined to Debtors and Creditors Accounts but is found in many other branches of accounting.

Examples are: Share Capital Accounts; Dividend Accounts; Hire Purchase Accounts; Double Entry Cost Accounts; Goods on Sale or Return; Solicitors' Accounts. In all these cases there is (or may be) a Total Account prepared on the principles already outlined.

Secret Accounts. It is a frequent practice to keep certain accounts secret from all but a few responsible higher officials—such accounts being Capital, Fixed Assets, Reserves, Profit and Loss, Taxation, Directors' Fees, Commissions, Dividends, and so on. This can be done by segregating the relevant accounts in the Private Ledger which is kept by one of the higher officials. It is obvious that, in order to maintain the secrecy, a separate or No. 2 Bank Account must be used and that a separate Cash Book must be written up and the relevant vouchers kept away from the normal business ones. All these must be kept secret from the general staff.

In order that a Trial Balance may be extracted by the general staff without revealing the detailed balances in the Private Ledger and Cash Book, the latter will be represented in the Nominal Ledger (in which the general accounts are kept) by a Total Account, called the Private Ledger Adjustment Account, a corresponding Nominal Ledger Adjustment Account being kept in the Private Ledger. Provided that the two Adjustment Account balances agree (as they should do), the detailed Private Ledger balances may be substituted by one of the higher officials for the Private Ledger Adjustment Account balance appearing in the Trial Balance taken out by the general staff. Needless to say, a Trial Balance should first be extracted from the Private Ledger to ensure that the balances of the accounts therein equal the balance of the Adjustment Account.

When the system is first started, the asset and other debit balance accounts will be transferred to the Private Ledger by crediting the individual accounts in the Nominal Ledger and debiting Private Ledger Adjustment Account, then crediting Nominal Ledger Adjustment Account and debiting the various accounts in the Private Ledger, and *vice versa* in respect of Capital, Reserves and other credit balance accounts. When it is desired to transfer cash from the General to the Private Bank account, the entries will be Dr. Private Ledger Adjustment Account, Cr. General Bank Account,

Dr. Private Bank Account, Cr. Nominal Ledger Adjustment Account. Directors' Fees, Dividends, etc., will be paid by debiting the respective accounts in the Private Ledger and crediting Private Bank Account.

When accounts are prepared, the general accounts in the Nominal Ledger will be closed off to the Private Ledger Adjustment Account, the entries appearing on reverse sides in the Nominal Ledger Adjustment Account in the Private Ledger, whence they will be transferred, along with the balances of the Private Ledger Accounts to the Profit and Loss Account.

The system is sometimes operated with one bank account only, two or more Cash Books being used, one for secret entries and one or more for general transactions, the totals of the latter being periodically entered in the "secret" Cash Book. The disadvantage of this method is that it is obviously necessary to keep the Pass Book away from the general staff, since otherwise the private receipts and payments will no longer be secret, and therefore the checking of the Pass Book must be done by one of the higher officials.

CHAPTER XI

SINGLE ENTRY

SINGLE entry book-keeping is a term which is in many cases very loosely employed without any real regard to the exact nature of the book-keeping system in question. Single entry is discussed in this chapter under two headings—

(1) Pure single entry.
(2) Single entry in the popular sense.

Pure Single Entry. Under this system the twofold aspect of each transaction as considered in the double entry system is ignored. The essential characteristic of this system is the keeping of Personal Accounts only; that is, no Real or Nominal Accounts find a place in the books of account. Such a book-keeping method is incomplete and unsatisfactory and it is clear that accurate information of the operations of the business is entirely lacking.

When the pure single entry system is in use the profit or loss for a period is ascertained by comparing the capital at the end of the period with that at the beginning, adjustments being effected in respect of withdrawals or introductions of capital during the period. If the closing capital exceeds the opening capital, such excess is considered to be profit for the period, and if the opening capital exceeds the closing capital, such excess is considered to be a loss for the period, subject to the adjustments mentioned above. Capital is, of course, the excess of assets over liabilities when considered for this purpose.

Illustration.

	£
Capital at 1st January, 19..	1,000
Capital at 31st December, 19..	1,500

The profit for the year ended 31st December, 19.., is therefore £500, i.e. £1,500 – £1,000.

	£
Capital at 1st January, 19..	800
Capital at 31st December, 19..	600

The loss for the year ended 31st December, 19.., is therefore £200 (i.e. £800 – £600).

Two very important points requiring adjustment in ascertaining the profits under pure single entry are additions to, and withdrawals of, capital. As explained above, any increase of capital during the period is considered as profit, and any decrease as loss; but capital introduced from outside sources cannot be considered in the light of profit, and must consequently be added to losses or deducted from profits when ascertained as above, and withdrawals similarly

cannot be considered as losses but must be either added to profits or deducted from losses.

The rule in regard to the adjustment for withdrawals of capital may be shortly stated thus—In order to ascertain profit or loss withdrawals must be (*a*) *added* to the increase of capital or (*b*) *deducted* from the decrease of capital.

Introductions of capital must be adjusted in exactly the converse manner, e.g. in order to ascertain profit or loss, introductions of capital must be (*a*) *deducted* from the increase of capital, or (*b*) *added* to the decrease of capital.

The following example illustrates the principles enunciated—

Illustration.

Business	A	B	C	D
	£	£	£	£
Opening Capital	1,000	2,200	1,600	1,000
Closing Capital	2,000	2,000	1,500	1,200
Drawings	400	400	—	400
Introduction of Capital	600	—	200	700

The results of the businesses as regards profit or loss are as follows—

Business A: £2,000 − £1,000 = £1,000 + £400 − £600 = £800 Profit
" B: £2,000 − £2,200 = − £200 + £400 = £200 "
" C: £1,500 − £1,600 = − £100 − £200 = £300 Loss
" D: £1,200 − £1,000 = £200 + £400 − £700 = £100 "

Preparation of Statement of Profit. In practice, the following method is adopted—(1) The opening and closing statements of affairs are compiled and from them the opening and closing capitals are obtained. As no records of Real Accounts are kept in the books such statements will have to be prepared from information supplied by the proprietor himself, and from such other data as may be available. (2) Totals are made of withdrawals and introductions of capital during the period. (3) The particulars so obtained are presented in double entry form by opening two accounts called "Statement of Profit" and "Capital Account," and such are compiled by applying the principles already outlined which may be summarized as follows—

(*a*) Debit Statement of Profit and credit Capital Account for the opening capital; *vice versa* for deficiency, i.e. where liabilities exceed assets.

(*b*) Debit Statement of Profit and credit Capital Account for capital introduced during the period.

(*c*) Debit Capital Account and credit Statement of Profit for withdrawals of capital during the period.

(*d*) Credit the Statement of Profit with the closing capital, as

disclosed by the closing Statement of Affairs, and bring this figure down as a debit balance on this account.

(*e*) Transfer the balance of the Statement of Profit to the debit (or credit) of Capital Account according as a loss (or a profit) has resulted.

In subsequent years the same procedure as regards (*b*), (*c*), (*d*), and (*e*) only will be followed, as the credit balance of Capital at the commencement of each year will equal the debit balance on Statement of Profit brought down from the preceding year.

The credit balance on the Capital Account will now be similar to the debit balance brought down on the Statement of Profit.

The capital figure represents the excess of assets over liabilities, or *vice versa*, and the accounts may be presented in Balance Sheet form under the heading of "Statement of Affairs." It is usual also to prepare a Statement of Affairs as at the beginning of the period to determine the amount of the opening capital.

If it is desired to record Depreciation, Provision for Bad Debts, and similar provisions in the Statement of Profit, it is necessary to bring down the closing capital intact, i.e. at the full figure, to debit separately the depreciation or other provision to the Statement of Profit, bringing such provision down separately as a credit balance, and finally to offset these balances and bring down the net balance on the Statement of Profit which will correspond with the balance shown by the Capital Account.

Illustration. X keeps his books on the single entry principle. The following information is disclosed—

Assets and Liabilities	1st Jan., 19..	31st Dec., 19..
	£	£
Fixtures and Fittings	2,000	2,000
Stock	1,000	1,250
Debtors	2,100	3,400
Cash	150	200
Creditors	1,750	1,900
Bills Payable	Nil	300
Loan by Y	Nil	500
Investments at 31st December, 19..	Nil	1,000

X has drawn £500 on account of his profits. Fixtures and Fittings are to be written down to £1,800 and the proprietor wishes to create a Bad Debts Provision of 10 per cent on debtors.

A Statement of Affairs is drawn up at 1st January, 19.., from which the opening capital is ascertained. The closing capital (before providing for depreciation and bad debts) will be obtained by deducting the liabilities from the assets, since the Capital Account is not overdrawn, and from the information thus obtained a Statement of Profit will be drawn up and finally a detailed Statement of Affairs at 31st December, 19...

STATEMENT OF AFFAIRS AS AT 1ST JANUARY, 19..

	£		£
Sundry Creditors	1,750	Fixtures and Fittings	2,000
Balance, being Capital at this date	3,500	Stock	1,000
		Sundry Debtors	2,100
		Cash	150
	£5,250		£5,250

The capital at the close of the period is ascertained thus—

	£	£
ASSETS—		
Fixtures and Fittings		2,000
Stock		1,250
Debtors		3,400
Cash		200
Investments		1,000
		7,850
LIABILITIES—		
Creditors	1,900	
Bills Payable	300	
Loan by Y	500	
		2,700
Capital at 31st December, 19..[1]		£5,150

The Statement of Profit will be as follows—

STATEMENT OF PROFIT FOR THE YEAR ENDED 31ST DECEMBER, 19..

Dr. *Cr.*

Date				£	Date			£
19.. Jan. 1	To Opening Capital		b/d	3,500	19.. Dec. 31	By Drawings		500
Dec. 31	" Depreciation	£200				" Closing Capital	c/d	5,150
	" Bad Debts Provision	340	c/d	540				
	" Balance — Net Profit transferred to Capital Account			1,610				
				£5,650				£5,650
	To Closing Capital		b/d	5,150		By Depreciation and Bad Debts Provision	b/d	540
						" Balance	c/d	4,610
				£5,150				£5,150
19.. [2]Jan. 1	To Balance		b/d	4,610				

Dr. CAPITAL *Cr.*

Date			£	Date			£
19.. Dec. 31	To Drawings		500	19.. Jan. 1	By Balance	b/d	3,500
	" Balance	c/d	4,610	Dec. 31	" Statement of Profit—Net Profit		1,610
			£5,110				£5,110
				19..[2] Jan. 1	By Balance	b/d	4,610

[1] Before providing for depreciation and bad debts.
[2] Following year.

STATEMENT OF AFFAIRS AS AT 31ST DECEMBER, 19..

		£			£
Sundry Creditors		1,900	Fixtures and Fittings	£2,000	
Loan		500	*Less* Depreciation	200	
Bills Payable		300			1,800
Capital at 1st Jan.,			Stock		1,250
19..	£3,500		Sundry Debtors	£3,400	
Less Drawings	500		*Less* Provision	340	
					3,060
	3,000		Investments		1,000
Add Net Profit	1,610		Cash		200
		4,610			
		£7,310			£7,310

Students should be very careful to avoid stating that one of the methods of ascertaining profits and losses under *pure* single entry is by conversion to double entry, as this cannot be done when pure single entry is in force. Should, however, adequate records be available, then the results obtainable arise from double entry and not single entry.

Single Entry in the Popular Sense. Single entry in the popular sense or quasi single entry are terms covering numerous systems of book-keeping which, though differing one from the other in detail, are all characterized by one common feature, viz. the lack of completeness of the double entry.

It may be that a Cash Book is kept, but no Day Books, even though the business is not entirely on a cash basis; or it may be that no Personal Accounts are kept, or that full Personal Accounts are written up on double entry lines, but no Nominal Accounts kept. In short, whenever the system employed is such that a Trial Balance cannot ensue from the books, it cannot be accurately described as a double entry system. From this, however, it should not be inferred that because the formal Day Books are not kept that the full double entry results cannot be achieved, for many "short cut" methods are employed as a means to complete the double entry.

Therefore, whenever a system is in force which goes beyond the keeping of Personal Accounts yet falls short of a complete system of double entry, it may be designated quasi single entry. It will usually be possible in the above circumstances to build up the double entry, i.e. to convert the partial double entry to a complete double entry. There are, then, two methods of ascertaining profits and losses under a single entry system in its comprehensive sense—

(1) **Pure Single Entry.** By means of the Statement of Profit method as previously mentioned. Such a method will be adopted when the information is sufficient to enable one to find opening and closing assets and liabilities, drawings, and introduction of capital.

(2) **Conversion to Double Entry.** The number of entries necessary to complete the true double entry will vary according to the degree of completeness already existing in the books. A typical set of books kept under a quasi single entry system comprises—Purchases, Purchases Returns, Sales, and Sales Returns Books, the items from

which are posted in detail to the relevant personal accounts, no posting being made of the periodical Day Book totals as no nominal accounts are kept; a cash book ruled in the familiar three-column style in which all receipts and payments are entered as made, together with all discounts either received or allowed. The cash (and discount) received from debtors, and paid to creditors, are posted to the respective personal accounts, the items in respect of personal accounts alone being posted. To put such a set of books on a true double entry basis for an accounting period, the following procedure will be necessary. A Statement of Affairs at the beginning of the period must be prepared and all the items therein (except Debtors and Creditors, and Cash and Bank, which are already in the books) must be debited or credited to the appropriate accounts in the Nominal Ledger. All assets will be on the debit and all liabilities on the credit side of the books. The balancing item will be Capital Account, which may be a debit or a credit. Now, so far as relates to the entries at the commencement of the period in question, the books are in balance. The double entry in respect of all the transactions of the period must now be completed.

The totals of the subsidiary books will be posted to the appropriate side of the respective nominal accounts, and the totals of the discount columns in the Cash Book transferred to the Discount Accounts. The Cash Book will now be scrutinized for unposted items, all of which will be posted to the appropriate accounts which will generally be Nominal or Real Accounts, e.g. Rates paid, Additions to Plant, Dividends and Rents received. Occasionally, it will be found that withdrawals of cash by the proprietor have not been posted or even entered in the Cash Book.

The degree of incompleteness of the double entry and the data available for bridging the gap must necessarily vary in every business, so that an attempt to lay down a detailed formula would be most misleading and futile. As a rule, however, it is first essential to *obtain the opening figures* (through the Statement of Affairs) and to open the necessary accounts to record them, including Capital Account, with the exception of the Cash and Bank items, and Debtors and Creditors, which are already recorded in the books; secondly, each book of original entry must be dealt with separately, the double entry being completed by posting the necessary figures. If any of these books are not completely written up it will be necessary to enter the missing items.

Before dismissing the matter an instance may be taken where the full double entry exists except that the Bought Ledger is compiled direct from the invoices and credit notes, and from the Cash Book in the usual way. It will readily be perceived that the Purchases and Returns figures must be extracted from the Bought Ledger. The Purchases Account will be debited with the ascertained total, and the Purchases Returns Account will be similarly credited. This may be illustrated by a simple example, as there is no difference

in *principle* whatever between such an example and one which embraces a considerable number of detailed Ledger Accounts.

Illustration. The following are accounts extracted from a Bought Ledger compiled as described above—

Dr. B *Cr.*

		£			£
To Cash and Discount .		120	By Goods . . .		200
,, Returns . . .		20	,, ,, ...		50
,, Balance . . .	c/d	110			
		£250			£250
			By Balance . .	b/d	110

Dr C *Cr*

		£			£
			By Goods		100

Dr D *Cr*

		£			£
To Cash and Discount		100	By Balance . . .	b/d	130
,, Balance . .	c/d	340	,, Goods . .		310
		£440			£440
			By Balance . .	b/d	340

Dr E *Cr.*

		£			£
To Cash and Discount .		46	By Balance . .	b/d	50
,, Returns . . .		4			
		£50			£50

Dr F *Cr*

		£			£
To Cash		40	By Balance . . .	b/d	10
			,, Goods		30
		£40			£40

The Bought Ledger will be analysed—

Personal Account	Closing Balances	Cash and Discount	Returns	Total	Purchases	Opening Balances
	£	£	£	£	£	£
B	110	120	20	250	250	
C	100			100	100	
D	340	100		440	310	130
E		46	4	50		50
F		40		40	30	10
	£550	£306	£24	£880	£690	£190

From the above analysis the total of Purchases Returns, i.e. £24, will be posted to the credit of Purchases (Returns) Account, and the total of Purchases, i.e. £690, will be posted to the debit of Purchases Account. The items of cash and discount entered on the debit side of the Ledger Accounts have their credit entries in the Cash Book.

Usually a certain number of abnormal items will appear in the Ledger Accounts, and accordingly a special column will be provided in the analysis for the record of such items, the total of which column will have to be sub-analysed and posted to the different ledger accounts in question: e.g. if F had been sent a bill of exchange for £40 instead of cash, the £40 would be inserted in a special column, and (together with any other bills payable) would be posted to the credit of Bills Payable Account. Very probably in this case the payment of the bill through the Cash Book would not have been posted, and the double entry in respect of the Cash Book entry would be effected by debiting the amount to Bills Payable Account.

Once the Trial Balance has been compiled, the Final Accounts are prepared in the normal manner, dealing with the usual accruals, prepayments, and other provisions.

When books are kept on a pure single entry system and it is desired to convert them to the double entry system in respect of future periods, a Statement of Affairs must be prepared from all available information, and all the items therein, including the balancing item of capital (except the Debtors and Creditors, Cash and Bank figures, which are already in the books), entered in the various ledgers on the debit and credit side according to whether the item in question is an asset or a liability. The books are now in balance and subsidiary books must be opened to record the transactions, the ordinary double entry system being fully carried out.

It is possible, as a matter both of practice and for examination purposes, if the beginning capital (with details of assets and liabilities) is available together with analyses of the Sales and Purchases Ledgers, and the Cash Book, to convert the system of quasi single entry in force for the preceding period into a full double entry structure. This matter is important inasmuch as the more advanced problems almost invariably resolve themselves into performing three distinct operations—

(1) Preparation of a Statement of Affairs.
(2) Analysis of Sales and Purchases Ledgers.
(3) Analysis of Cash Book.

The problem presented may disclose part only of the above information from which the required conversion is to proceed, and it is generally found that insufficient attention is paid to the Statement of Affairs (with the inclusion of capital) and the working of the double entry from the items appearing therein.

In examination work there is usually no time to open *all* the Ledger Accounts, but they must be treated as though they had been

opened. In the following example the Ledger Accounts will be opened in full, and it will be noted that the opening Debtors and Creditors, and Cash and Bank figures are ALREADY in the appropriate accounts.

It will be seen that a quicker way of dealing with most of the items (save Debtors and Creditors and Cash and Bank) is to place them directly in the Trial Balance, because even if such accounts are opened the items will remain undisturbed, and therefore the direct entry to the Trial Balance effects a very valuable economy in time. This device applies equally well to the postings of the nominal items from the Cash Book.

Illustration. M. Scipio wishes to have his books converted to double entry in order that he may keep them on this basis in future years, and also to have a Trading and Profit and Loss Account and Balance Sheet drawn up in respect of the year to 31st December, 19... His expenses are kept in a rough Cash Book and his Bank transactions are found from the pass book. An analysis of the various accounts will be made on the following lines.

The opening Statement of Affairs discloses the following position—

STATEMENT OF AFFAIRS AS AT 1ST JANUARY, 19..

		£			£
Sundry Creditors		450	Cash in Hand	£50	
Balance, being Capital at this date		950	Cash at Bank	100	
					150
			Sundry Debtors		600
			Stock		400
			Plant and Machinery		250
		£1,400			£1,400

The following are the analyses—

Dr ANALYSIS OF THE SALES LEDGER ACCOUNTS *Cr.*

		£			£
To Balances at 1st Jan., 19	b/d	600	By Cash		3,470
,, Sales	T.B.	4,000	,, Discounts Allowed	T B	120
			,, Returns	T B	240
			,, *Contras* (Purchases Ledger)	C	70
			,, Balances at 31st Dec., 19 c/d	T B	700
		£4,600			£4,600
To Balances	b/d	700			

Dr ANALYSIS OF THE PURCHASES LEDGER ACCOUNTS *Cr*

		£			£
To Cash and Cheques		2,170	By Balances at 1st Jan., 19	b/d	450
,, Discounts Received	T B	50	,, Purchases	T.B	2,500
,, Returns	T B	160			
,, *Contras* (Sales Ledger)	C.	70			
,, Balances at 31st Dec., 19 c/d	T.B.	500			
		£2,950			£2,950
			By Balances	b/d	500

Note. "T.B." in the folio column signifies that the item appears in the Trial Balance.

These items will be posted to their respective accounts and as a consequence every item in either the Sales or the Purchases Ledger will have an opposite entry elsewhere, the double entry being thus completed.

Dr. CASH BOOK SUMMARY *Cr.*

		Cash	Bank			Cash	Bank
		£	£			£	£
To Balances .	b/d	50	100	By Cash to Creditors	P.L.	170	2,000
,, Cash from Debtors .	S.L.	3,470		,, Expenses (detailed) .	T.B.	940	
,, Capital introduced .	L	1,000		,, Drawings .	T.B.	260	
,, Cash: *Contra* .	C		3,000	,, Bank: *Contra* .	C.	3,000	
				,, Balances .	c/d	150	1,100
		£4,520	£3,100			£4,520	£3,100
To Balances .	b/d	150	1,100				

The Capital Account is in credit as below—

		£
By Balance .	b/d	950
,, Cash (C B.) .	.	1,000
		£1,950

All the expenses will be posted to their respective accounts. Cash introduced will be credited to Capital Account; Drawings may be posted to the debit of a Drawings Account and thence transferred to Capital Account, or alternatively posted direct to the debit of Capital Account.

Complete double entry will now have been effected, and accordingly a Trial Balance at 31st December, 19.., may be extracted, and a Trading and Profit and Loss Account and a Balance Sheet prepared therefrom. Closing Stock is £480.

M. SCIPIO

TRIAL BALANCE AS AT 31ST DECEMBER, 19..

		Dr.	Cr.
		£	£
Capital .	L.		1,950
Sales .	S.L.		4,000
Sales Returns .	S.L.	240	
Purchases .	P.L.	2,500	
Purchases Returns .	P.L.		160
Discounts Allowed .	S.L.	120	
Discounts Received .	P.L.		50
Drawings .	C.B.	260	
Expenses (detailed) .	C.B.	940	
Sundry Debtors .	S.L.	700	
Sundry Creditors .	P.L.		500
Stock .	S.A.	**400**	
Plant and Machinery .	S.A.	**250**	
Cash .	C.B	150	
Bank .	C.B.	1,100	
		£6,660	£6,660

Trading and Profit and Loss Account for the Year Ended 31st December, 19..

Dr.			£	Cr.			£
To Stock			400	By Sales	£4,000		
„ Purchases	£2,500			*Less* Returns	240		3,760
Less Returns	160		2,340	„ Stock			480
„ Gross Profit		c/d	1,500				
			£4,240				£4,240
To Expenses (detailed)			940	By Gross Profit		b/d	1,500
„ Discounts Allowed			120	„ Discounts Received			50
„ Net Profit			490				
			£1,550				£1,550

Balance Sheet as at 31st December, 19..

			£				£
Sundry Creditors			500	Cash in Hand	£150		
Capital at 1st Jan., 19..	£950			Cash at Bank	1,100		1,250
Less Drawings	260			Sundry Debtors			700
	690			Stock			480
Add Net Profit	490			Plant and Machinery			250
Cash introduced	1,000		2,180				
			£2,680				£2,680

Questions are very often set on single entry systems, it being required to convert them to double entry, and to prepare a Trading and Profit and Loss Account therefrom. To do this it is necessary to "build up" various accounts from the information given in the question. The following illustration is of such a type and should be checked up by the student, item by item.

Illustration. A client submits to you the following figures relating to his business in respect of the year to 31st December, 19... You are required to prepare a Trading and Profit and Loss Account for the year ended, and a Balance Sheet as at 31st December, 19... Any difference in the Cash balance is assumed to be drawings.

	£
Cash paid into Bank	8,690
Private Dividends paid into the Business (Cash)	200
Private Payments out of Bank	750
Business Payments out of Bank	7,750
Cash and Cheques from Debtors	11,700
Payment for Goods by Cash and Cheques	7,950
Wages	1,500
Delivery Expenses	600
Rent and Rates	135
Lighting and Heating	90
General Expenses	250
Bank Interest Received	10

The Assets and Liabilities are as follows—

Assets and Liabilities	1st Jan., 19..	31st Dec., 19..
	£	£
Stock	600	750
Bank Balances	800	1,000
Cash in Hand	30	20
Trade Debtors	750	1,050
Trade Creditors	1,200	1,400
Investments	3,000	3,000

Any goods drawn out by the trader have been paid for by cash.

As in the previous examples, the first requisite is to prepare an opening Statement of Affairs to find the opening capital, after which the balances of debtors and creditors, cash and bank will be opened in their respective accounts, the remaining items being taken direct to the Profit and Loss Account and Balance Sheet (instead of opening the actual accounts). The double entry will be compiled through the medium of these accounts, expenses from the Cash Book being transferred direct to Profit and Loss Account (again, to save time, the Trial Balance being dispensed with).

The Cash Book will be written up and the balances therein should correspond with those shown in the opening Statement of Affairs. The receipts from customers will be posted to the credit of Sundry Debtors Account. The closing balances of Debtors in total will be credited to the Sundry Debtors Account and brought down as an item to be shown in the Balance Sheet. The balancing figure on the account will be "Sales" which will be debited to Sundry Debtors Account and credited to Trading Account.

The item of investments remains at £3,000 and will be merely carried forward from Balance Sheet to Balance Sheet.

A Sundry Creditors Account will be written up on the same principle as the Sundry Debtors Account, and from it the "Purchases" figure will be obtained.

It will be seen that all the items given have been covered save the closing stock. This will be dealt with in the usual way, i.e. debit Stock Account and credit Trading Account (or in this example, where time saving methods are adopted, the stock figure will be taken direct to the Balance Sheet, no Stock Account being written up).

As the trader lives on his business premises, one-third of the lighting and heating, and of the rent and rates, has been treated as a personal expense and thus charged as drawings. The proportion to be so dealt with cannot usually be ascertained with meticulous accuracy, but as the income tax practice is, generally, to allow two-thirds of such mixed expenditure as legitimate charges against profits, it is reasonable to consider that one-third is a fair proportion of such expenses to be attributed to private living.

Dr. **Total Creditors** *Cr.*

19 Dec. 31	To Cash and Cheques .		£ 7,950	19.. Jan. 1	By Balances . . .	b/d	£ 1,200
	„ Balances . . .	c/d	1,400	Dec. 31	„ **Purchases**. . .		**8,150**
			£9,350				£9,350
				19 . Jan. 1	By Balances . . .	b/d	1,400

Dr. **Total Debtors** *Cr.*

19 Jan 1	To Balances . . .	b/d	£ 750	19 . Dec. 31	By Cash . . .		£ 11,700
Dec 31	„ **Sales** . . .		**12,000**		„ Balances . . .	c/d	1,050
		£	12,750			£	12,750
19 Jan. 1	To Balances . . .	b/d	1,050				

Dr. **Cash Book** *Cr.*

			Cash	Bank				Cash	Bank
19 Jan. 1	To Balances .	b/d	£ 30	£ 800	19 Dec 31	By Bank: *Contra*.		£ 8,690	£
Dec 31	„ Cash: *Contra* .			8,690		„ Wages . .		1,500	
	„ Sales . .		11,700			„ Delivery Expenses .		600	
	„ Dividends .		200			„ Rent and Rates .		135	
	„ Bank Interest			10		„ Lighting and Heating .		90	
						„ General Expenses .		250	
						„ Drawings .	(*a*)	**445**	**750**
						„ Purchases .	(*b*)	200	**7,750**
						„ Balances .	c/d	20	1,000
		£	11,930	£9,500			£	11,930	£9,500
19 Jan 1	To Balances .	b/d	20	1,000					

Notes (*a*) The Cash Drawings item is a balancing figure.

(*b*) It will be observed that the payment for goods, £7,950, is made up of £7,750 bank payments (as per question) and £200 cash payments. This is easily found, as the item required to balance the Bank columns is £7,750.

Items in heavy type are balancing figures.

Dr. **Trading and Profit and Loss Account for the Year Ended 31st December, 19..** *Cr.*

To Stock		£ 600	By Sales		£ 12,000
„ **Purchases** . . .		8,150	„ Stock		750
„ **Gross Profit** . . .	c/d	4,000			
	£	12,750		£	12,750
To Wages		1,500	By Gross Profit . . .	b/d	4,000
„ Delivery Expenses .		600	„ Bank Interest . .		10
„ Rent and Rates . .		90			
„ Lighting and Heating .		60			
„ General Expenses . .		250			
„ Net Profit . . .		1,510			
		£4,010			£4,010

BALANCE SHEET AS AT 31ST DECEMBER, 19..

		£			£
Creditors		1,400	Cash in Hand . .	£20	
Capital at 1st Jan., 19 .	£3,980		Cash at Bank . .	1,000	
Add Dividends .	200				1,020
Net Profit .	1,510		Debtors		1,050
	5,690		Stock		750
Less Drawings £1,195 & Rent, etc . 75	1,270		Investments . .		3,000
		4,420			
		£5,820			£5,820

Note. The question states "private dividends," so that the amount is a credit to capital, but it should be noted that as there is an item of investments in the Balance Sheet, it may be that some or all of the dividends mentioned may arise from the business assets, in which case they would be credited to Profit and Loss Account.

Questions involving the principle of conversion of single entry into double entry may be presented in an infinite variety of ways, but all will demand, in common, the method of first preparing the opening Statement of Affairs (or such part as may be immediately prepared) and obtaining the opening figures therefrom, followed by the opening of the vital accounts, viz. Cash and/or Bank, Debtors and Creditors. It will then generally be necessary to place in such accounts the information given, by the utilization of which a double entry system may be constructed and any "missing" items determined.

As an example, information may be given as to a trader's assets and liabilities as at the beginning date, with the exception that the figure for opening debtors is missing, so that without further data it is impossible to ascertain the capital at that date. Nevertheless, the Statement of Affairs should be written up, leaving blanks for the items—"Capital" and "Debtors." The three or four vital accounts should be opened and, as the writing up of the accounts proceeds, it usually will be possible to obtain the figure for opening debtors, as the sales will generally be disclosed by the question and also the closing debtors figure. It will still be necessary to find the cash received from debtors, but if this item is not given, it will be necessary perhaps to turn to the Cash Book to see whether the receipts from debtors can be deduced therefrom. If the Cash Book information is complete in all respects save this figure (as on the above hypothesis it has not been given in the question) the balancing item will be, *prima facie*, "Receipts from Debtors." Once this figure is ascertained, it is credited to "Sundry Debtors Account," which account is now complete save for the opening debtors figure which will be a balancing item. The opening Statement of Affairs may now be completed by inserting the debtors figure, and consequently, the opening capital ascertained.

Illustration. The following information is supplied, from which you are required to prepare Trading and Profit and Loss Account for the year ended, and Balance Sheet as on, 31st December, 19...

Assets and Liabilities	1st Jan., 19..	31st Dec., 19..
	£	£
Creditors	1,577	1,240
General Expenses Owing	60	33
Sundry Assets	1,161	1,204
Stock	804	1,112
Cash in Hand and at Bank	696	808
Debtors	?	1,787

Details relative to the year's transactions are—

	£
Cash and *Discount* credited to Debtors (*a*) See item (*b*)	6,400
Returns from Debtors	145
Bad Debts	42
Sales—Cash and Credit	7,181
Discount Allowed by Creditors	70
Returns to Creditors	40
Capital Introduced (paid into Bank)	850
Receipts from Debtors (paid into Bank) (*b*) See item (*a*)	6,250
Cash Purchases	103
Expenses paid by Cash	957
Purchase of Machinery by Cheque	43
Drawings by Cheque	318
Cash Payments into Bank	500
Withdrawn from Bank into Cash	924
Cash in Hand at end	120
Payments to Creditors by Cheque	6,027

The accounts are as follows—

Dr. ANALYSIS OF CASH BOOK, 19.. *Cr.*

			Cash	Bank				Cash	Bank
19			£	£	19..			£	£
Jan. 1	To Balances	b/d	296	400	Dec. 31	By Cash Purchases		103	
Dec. 31	" Cash Sales (see Note 4)		460			" Expenses		957	
	" Capital introduced			850		" Plant and Machinery (purchased)			43
	" Debtors			6,250		" Drawings			318
	" Bank: *Contra*		924			" Creditors			6,027
	" Cash: *Contra*			500		" Cash: *Contra*			924
						" Bank: *Contra*		500	
						" Balances	c/d	120	688
			£1,680	£8,000				£1,680	£8,000
19.. Jan. 1	To Balances	b/d	120	688					

The connecting links are arrived at in the following sequence—

(1) Deduct from the Cash and Bank Balance at 31st December, 19.. (£808), the cash balance at that date (£120) to give the closing bank balance.

(2) The resultant balance (£688) will enable the opening bank balance to be arrived at (£400).

(3) The opening cash balance can now be reckoned, viz. £696 less £400 = £296.

(4) This figure in turn will enable the figure of cash sales to be calculated, i.e. £460, being the balancing item in the Cash Column.

(5) The sales in the Debtors Account are now found by deducting the cash sales from the figure of cash and credit sales supplied by the question, i.e. £7,181 less £460 = credit sales £6,721.

(6) Discount allowed to customers is £6,400 less £6,250 = £150.

It will now be possible to prepare Total Debtors and Total Creditors Accounts to disclose the missing items, viz. opening Debtors and Capital at 1st January, 19.., and Purchases (on credit) and a Balance Sheet at 1st January, 19...

Dr. TOTAL DEBTORS *Cr.*

		£			£
To Balances	b/d	1,653	By Cash		6,250
„ Sales (see Note 5 above)		6,721	„ Discount		150
			„ Returns		145
			„ Bad Debts		42
			„ Balances	c/d	1,787
		£8,374			£8,374
To Balances	b/d	1,787			

Dr. TOTAL CREDITORS *Cr.*

		£			£
To Cheques		6,027	By Balances	b/d	1,577
„ Discount		70	„ Purchases		5,800
„ Returns		40			
„ Balances	c/d	1,240			
		£7,377			£7,377
			By Balances	b/d	1,240

BALANCE SHEET AS AT 1ST JANUARY, 19..

		£			£
Sundry Creditors	£1,577		Sundry Assets		1,161
General Expenses accrued	60		Stock		804
		1,637	Sundry Debtors		1,653
Capital		2,677	Cash in Hand	£296	
			Cash at Bank	400	
					696
		£4,314			£4,314

Dr. TRADING AND PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 19.. *Cr.*

		£			£
To Stock (Opening)		804	By Sales £7,181		
„ Purchases £5,903			*Less* Returns 145		
Less Returns 40					7,036
		5,863	„ Stock (Closing)		1,112
„ Gross Profit	c/d	1,481			
		£8,148			£8,148
To Discount		80	By Gross Profit	b/d	1,481
„ Bad Debts		42			
„ General Expenses [957 + 33 − 60]		930			
„ Net Profit, transferred to Capital Account		429			
		£1,481			£1,481

BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£	£		£	£
Sundry Creditors .	1,240				
General Expenses accrued . . .	33		**Sundry Assets** .	**1,161**	
		1,273	*Add* Additions .	43	1,204
Capital Account—			Stock		1,112
Balance, 1st Jan., 19.. .	**2,677**		Sundry Debtors . .		1,787
Amount introduced	850		Cash in Hand .	120	
Net Profit per Profit and Loss Account .	429		**Cash at Bank**	**688**	808
	3,956				
Less Drawings .	318	3,638			
		£4,911			£4,911

The opening figures are shown in heavy type.

Disadvantages of Single Entry. (1) Impossibility of obtaining accurate information as to results of trading operations.

(2) Unreliability of the information relative to assets and liabilities.

(3) As nominal accounts are not kept or, if kept, are generally of an incomplete character, interim accounts, or comparative or other statistical information cannot be obtained.

(4) Arising from above, difficulties will be likely to accrue to the proprietor should he desire to sell the business, ascertain goodwill for the purposes of sale, appeal against excessive income tax assessments, or obtain assistance in financing the business.

(5) The psychological effect is that the lack of double entry will engender lax accounting methods, thus opening the door to fraud and other evils.

(6) The check on arithmetical accuracy of postings and the elasticity and adaptability of the double entry system are lacking in the single entry system.

Capital Statements. Where the affairs of a person are in such a state of confusion, arising particularly from the mixing of private affairs with business, rendering compilation of accounts impossible, it is usual to estimate business profits by constructing a capital statement. The fluctuations of capital, subject to living expenses and private income, are taken to indicate the profit or loss for each period.

Illustration. The following figures summarize the position of X—

Assets and Liabilities	1st Jan., 1952	31st Dec., 1952	31st Dec., 1953
	£	£	£
Net Business Assets	4,000	3,800	3,700
Investments	1,700	2,100	2,750
Bank (overdrawn)	250	200	(in hand) 150
Car		100	100

	Year Ended 31st Dec., 1952	Year Ended 31st Dec., 1953
	£	£
Income from Investments	118	122
Bank Interest	18 (*Paid*)	3 (*Received*)
Drawings	450	500

It is required to ascertain the business profits for the years ended 31st December, 1952 and 1953.

First, it is necessary to find the total capital at the three dates, 1st January, 1952, 31st December, 1952 and 1953. Secondly, from these figures will be found the increase of capital in the two years ended 31st December, 1952 and 1953. Thirdly, the drawings will be added to this figure; and, finally, as the results obtained include profits, income and expenditure not arising from the business dealings, such must be deleted in order to arrive at the business profits.

The estimated business profits are obtained thus—

	1st Jan., 1952	31st Dec., 1952	31st Dec., 1953
	£	£	£
(*a*) Total Capitals—			
Net Business Assets	4,000	3,800	3,700
Investments	1,700	2,100	2,750
Car		100	100
Bank			150
	5,700	6,000	6,700
Less Bank (overdrawn)	250	200	
	£5,450	5,800	6,700
Less Capital at commencement of year		5,450	5,800
(*b*) Increase of Capital		350	900
(*c*) *Add* Drawings		450	500
		800	1,400
(*d*) *Less*—			
Income from Investments		118	122
Bank Interest Received			3 125
		682	1,275
Add Bank Interest Paid		18	
Business Profits		£700	£1,275

Proof—

Total Income—	£
Capital at 31st December, 1953 .	6,700
Capital at 1st January, 1952 .	5,450
Increase of Capital . . .	1,250
Add Drawings	950
Total Income . .	£2,200
Private Income—	£
Income from Investments . .	240
Less—	
Bank Interest (paid, less received)	15
	£225
Business Profits—	£
Total Income	2,200
Less Private Income . .	225
	£1,975

SUMMARY OF POSITION

	£
Capital at 1st January, 1952	5,450
Add Private Income	225
Business Profits	1,975
	7,650
Less Drawings	950
∴ Capital at 31st December, 1953 .	£6,700

ABRIDGED DOUBLE ENTRY

Though it is desirable that a full system of double entry book-keeping should be in operation in all businesses, be they large or small, intricate or simple, the exigencies of time and expense may frequently call for some system which, though falling short of the conventional completeness, can be constructed on double entry lines. Such a system is well adapted to the requirements of many businesses, particularly to those of small traders. The method of book-keeping described below is distinguishable from single entry in that it is an abridged form of double entry book-keeping; the personal accounts which normally form an integral part of the complete double entry system are not eliminated, but employed for reference purposes, and, as such, are "memorandum" only.

The characteristic feature of the system is that the double entry is completed from the Cash Book, i.e. receipts from debtors are considered as sales, and payments to creditors as purchases. At the end of the accounting period adjustments will be made in respect of

debtors and creditors outstanding, as well as for discounts, bad debts, allowances, and the like.

It will be seen, therefore, that such a system does not dispense with the necessity for Personal Accounts; but it avoids the necessity of employing the Day Books and Returns Books as a formal part of the double entry system, or the completion thereof through the Ledger analysis. Frequently, the latter books are employed to record sales, purchases and returns, postings being made therefrom to the Ledgers (or postings made direct from the invoices themselves if no such books are kept), but in such instances the Ledger is kept purely for record and is outside the double entry system entirely. Obviously as the cash is received or paid, it will be entered in the Memorandum Personal Accounts (i.e. posted in the usual way), but this is no part of the double entry, as such receipts and payments are posted to complete the double entry to Sales and Purchases Accounts respectively. It is to this point that the student should fix his attention, viz. that whatever is entered and wheresoever the original entries arise (except the entries in the Cash Book) they form no part of the double entry; the latter, as seen above, arises from the postings from the Cash Book to the Sales and Purchases Accounts.

At the end of the period the Personal Ledger balances will have to be extracted as if the orthodox system were employed, but only to provide the necessary data for preparing final accounts. These figures will be brought into the accounts and, as such, are of no more consequence to the double entry than is the end stock before its incorporation in the final accounts. In addition, there will usually be several adjustments required, e.g. for Discounts.

The rules may be outlined as follows—

(1) When cash is received from customers who have bought on credit the Cash Book is debited in the usual manner and the double entry is completed by a posting to the credit of Sales Account, precisely as if the transaction were a cash sale. A "posting" is made of such receipt in the Memorandum Personal Account in order that such account may show the true state of the customer's balance. Upon cash (or cheque) being paid to a creditor, Cash (or Bank) is credited in the usual manner, and the double entry is completed by a posting to the debit of Purchases Account, precisely as if the transaction were a cash purchase. A "posting" is made in the Memorandum Personal Account of the creditor in order that his account may record the true balance due to him.

(2) Expenses are treated on a cash basis; that is, no record is made until they are finally paid, when a debit is made direct to the requisite Nominal Account.

(3) At the end of the accounting period the Sales and Purchases Accounts will have been built up, not from Day Books (which, if kept, are purely memoranda), but from the Cash Book. In other

words, they will record the cash received from debtors and paid to creditors.

(4) The closing balances of debtors are brought down in the Sales Account as a debit balance; closing balances of creditors being brought down in the Purchases Account as a credit balance. The balances are respectively shown in the Balance Sheet as an Asset and a Liability.

(5) Discounts allowed will be debited to Discount Allowed Account and credited to Sales Account. Converse entries in respect of Discounts received will be made. The same rules apply to Returns and Allowances.

(6) If the closing balances of debtors are the *good* debts only, Bad Debts Account will be debited and Sales Account credited in respect of bad debts, but if such balances are the book balances, the entries required are—

Debit Bad Debts Account with bad debts.
Debit Sales Account (below the line) with good debtors.
Credit Sales Account (above the line) with book value of debtors.

(7) The Bad Debts Provision in no way affects the Sales Account.

Illustration. A starts business on 1st January, 1952. The following facts relate to his business for the two years ended 31st December, 1953.

Cash received from debtors, 1952, £1,000; ditto, 1953, £1,200. Debtors 31st December, 1952 (per Ledger) £100; ditto, 31st December, 1953 (per Ledger), £130. Discounts allowed, 1953, £10. Bad Debts, 1953, £25.

Show accounts assuming the trader keeps his Sales Ledger purely as a memorandum book.

Dr SALES *Cr.*

			£				£
1952 Dec. 31	To Trading Account		1,100	1952 Dec. 31	By Cash		1,000
					,, Sundry Debtors	c/d	100
			£1,100				£1,100
1953 Jan. 1	To Balance	b/d	100	1953 Dec. 31	By Cash		1,200
Dec. 31	,, Trading Account		1,240		,, Discounts Allowed		10
					,, Bad Debts		25
					,, Sundry Debtors	c/d	105
			£1,340				£1,340
1954 Jan. 1	To Balance	b/d	105				

Alternatively:

Dr.				SALES			*Cr.*
1952			£	1952			£
Dec. 31	To Trading Account .		1,100	Dec. 31	By Cash . . .		1,000
					„ Sundry Debtors .	c/d	100
			£1,100				£1,100
1953				1953			
Jan. 1	To Balance (*a*) . .	b/d	100	Dec. 31	By Cash . . .		1,200
Dec. 31	„ Trading Account .		1,240		„ Discounts Allowed .		10
					„ Sundry Debtors:		
					Balance . .	c/d	105
					Bad Debts . .		25
			£1,340				£1,340
1954							
Jan. 1	To Balance (*b*) . .	b/d	105				

(*a*) This item will appear as an asset on the Balance Sheet at 31st December, 1952.

(*b*) This item will appear as an asset on the Balance Sheet at 31st December, 1953; in addition £25 will appear as a debit in Bad Debts Account.

The Purchases Account would be treated conversely if credit purchases took place.

CHAPTER XII

RECEIPTS AND PAYMENTS, AND INCOME AND EXPENDITURE ACCOUNTS

THESE accounts should present no difficulties whatsoever to students once the function of each account is clearly understood.

Receipts and Payments Account. This is nothing more than a summary of the Cash Book (i.e. of cash and bank transactions), over a certain period. It is the form of account most commonly adopted by the treasurers of societies, clubs, associations, etc., when presenting the result of the year's working. All the receipts of each type (whether cash or cheque) are entered on the debit side, that is the same side as that on which they appear in the Cash Book; and all the payments (whether cash or cheque) are entered on the credit side. The opening and closing balances of cash and bank are shown in the usual way, unless (as is generally found) the cash and bank items are combined, when there will not be separate balances for cash *and* bank. The main features of the Receipts and Payments Account may be summarized thus—

(1) It is an abbreviated copy of the Cash Book, usually merging cash and bank items, *Contras* between Cash and Bank thus being eliminated.

(2) Hence the items are entered on the same side as that on which they appear in the Cash Book, i.e. receipts on the debit side, and payments on the credit.

(3) Just as the Cash Book itself may be part of the double entry book-keeping so may the Receipts and Payments Account. Accounts presented in this form however almost invariably suggest an absence of double entry.

(4) *All* receipts and payments whether of a revenue or a capital nature are included.

(5) The balance of Receipts and Payments Account must be debit, being Cash on hand and at Bank, unless there is a Bank overdraft, but that of Income and Expenditure Account may be debit or credit, being loss or profit, usually transferred, except in the case of a limited company, to the Capital Account.

(6) There is no disclosure of gains or losses, as the account does not—indeed cannot—deal with—

(*a*) Stock Increases or Decreases.

(*b*) Depreciation or Appreciation of assets.

(*c*) Provisions and Accruals or Prepayments.

whilst on the other hand it includes—

(*d*) Capital Receipts and Payments.

(*e*) Appropriations of Profits including Drawings.

No difficulty should arise if the NATURE rather than the name

of the account is recognized, particularly as many Receipts and Payments Accounts are often misdescribed, e.g. as an Income and Expenditure Account, or even as a Balance Sheet.

Illustration. A club which was inaugurated on 1st January, 19.., had the following receipts and payments during the year ended 31st December, 19..—Receipts: Subscriptions, £330; Donations, £26. Payments: Investments, £100; Rent and Hire of Room, £40; General Expenses, £21; Postages and Stationery, £7; and Sundries, £3.

Cash in hand at 31st December—£2.

Cash at Bank at 31st December—£183.

Show the Receipts and Payments Account for the year ended 31st December, 19..

RECEIPTS AND PAYMENTS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER 19..

Dr. *Cr.*

19 .	*Receipts*		£	19	*Payments*		£
Dec. 31	To Subscriptions		330	Dec. 31	By Investments		100
	,, Donations		26		,, Rent and Hire of Room		40
					,, General Expenses		21
					,, Postages and Stationery		7
					,, Sundries		3
					,, Cash in Hand	c/d	2
					,, Cash at Bank	c/d	183
			£356				£356
19 .							
Jan 1	To Cash in Hand	b/d	2				
	,, Cash at Bank	b/d	183				

From a study of the above account it will be apparent at once that the amount of £185 cannot be the year's profit, as—

(1) The first item on the credit side records the purchase of an ASSET.

(2) No account has been taken of subscriptions in arrear or in advance; nor of expenses accrued, accruing, or paid in advance.

This is obvious, the account being one dealing solely with receipts and payments through the medium of either Cash or Bank. In order to remedy the defective results thereby disclosed, it is necessary to prepare an Income and Expenditure Account usually by the construction of the double entry, in which case it will be supported by a Balance Sheet drawn up at the date of the close of the period in question.

Income and Expenditure Account. This may be described as the equivalent of the Profit and Loss Account drawn up for a non-trading concern; it performs the same functions, and is compiled and constructed on precisely the same principles. It is a nominal account recording losses and expenses on the debit, and gains on the credit, normally postulating the existence of a double entry system.

It may be noted that the balance of the Receipts and Payments Account is brought down below the line and shown in the Balance Sheet as an asset if a debit balance, or liability if a credit balance. The balance of the Income and Expenditure Account will be transferred to the debit or credit of the Capital Account (or its equivalent) according to whether a loss or gain has resulted.

The excess of assets over liabilities will, as in the case of clubs, societies, and other organizations not having a formal Capital Account, be represented by a Capital Fund Account, or Accumulation Fund to which the net gains or losses are transferred in the usual way, the revised figure of which will be shown in the Balance Sheet on the liabilities side. The adjustments of a general nature and those peculiar to the organization itself, the chief of which will be accruals, prepayments, provisions, depreciation, and the adjustment in Expenses of opening and closing stocks (e.g. Stationery), will be made in the normal manner.

Illustration. The following is an abridged Receipts and Payments Account—

Receipts		£	*Payments*	£
To Balance . . .	b/d	200	By Expenses . . .	317
,, Subscriptions . . .		520		

The outstandings are—

	Subscriptions	Expenses
	£	£
Beginning	40	120
End	37	39

Prepare Income and Expenditure Account.

Dr SUBSCRIPTIONS *Cr.*

		£			£
To Balance, outstandings (beginning) .	b/d	40	By Cash . . .		520
,, Income and Expenditure Account . .		517	,, Outstandings (end) .	c/d	37
		£557			£557
To Balance, outstandings .	b/d	37			

Dr. EXPENSES *Cr.*

		£			£
To Cash . . .		317	By Balance, outstandings (beginning) . .	b/d	120
,, Outstandings (end) .	c/d	39	,, Income and Expenditure Account . .		236
		£356			£356
			By Balance, outstandings .	b/d	39

Dr.	INCOME AND EXPENDITURE ACCOUNT			*Cr.*
	£			£
To Expenses . . .	236	By Subscriptions . .		517
„ Surplus transferred to Capital Fund . .	281			
	£517			£517

In examination work, in order to avoid opening the Ledger Accounts, the Income and Expenditure Account may be prepared thus—

Dr.	INCOME AND EXPENDITURE ACCOUNT						*Cr.*
	£	£	£		£	£	£
To Expenses Paid .	317			By Subscriptions Received	520		
Add Outstandings at end	39			*Add* Outstandings at end	37		
		356				557	
Less Outstandings at beginning . .		120		*Less* Outstandings at beginning . .		40	
			236				517
Surplus transferred to Capital Fund			281				
			£517				£517

The items may be presented in a manner more abbreviated (which is recommended in simple adjustments), thus—

	£		£
To Expenses (317 + 39 − 120)	236	By Subscriptions (520 + 37 − 40)	517

It must be remembered that the beginning outstandings are part of the OPENING balances; those at the end part of the END balances (and therefore in the Balance Sheet prepared in conjunction with the Income and Expenditure Account for the period under review): hence in the above case £37 is an asset; £39 a liability.

Many examination problems involve the compilation of an Income and Expenditure Account and a Balance Sheet from a summarized Receipts and Payments Account. Students, when confronted by this type of problem, should always build up the opening Balance Sheet or Statement of Affairs, particulars of the assets and liabilities of which are usually given. The opening cash balance will be found from the Receipts and Payments Account, whilst the creditors may appear in total under the heading of creditors, or the expense creditors may appear separately, being found on the credit of the respective expense accounts which represent the service supplied. Particulars of the adjustments necessary will be given at the foot of the Receipts and Payments Account, and these (*mutatis mutandis*) are made in the same way as the usual Trading and Profit and Loss Account and Balance Sheet adjustments.

Illustration. The following is the Receipts and Payments Account of the Y. G. Club in respect of the year to 31st December, 1952—

RECEIPTS AND PAYMENTS FOR THE YEAR ENDED 31ST DECEMBER, 1952

Dr. *Cr.*

			£				£
1952 Jan. 1	To Balance . . .	b/d	205	1952 Dec. 31	By Salaries . . .		416
Dec. 31	,, Subscriptions—				,, Stationery . .		80
	1951 . . £8				,, Rates . . .		120
	1952 . . 422				,, Telephone . .		20
	1953 . . 16		446		,, Investment in £250 4% Stock (6th Dec.) at par . . .		250
	,, Sports Meeting Profit .		310		,, Sundry Expenses .		185
	,, Dividends on Investments . . .		200		,, Balance . . .	c/d	90
			£1,161				£1,161
1953 Jan. 1	To Balance . . .	b/d	90				

In addition to information contained in the above account the following additional facts are ascertained—

(1) There are 450 members each paying an annual subscription of £1, £9 being in arrears for 1951 at the beginning of 1952.

(2) Stock of Stationery at 31st December, 1951, was £10; at 31st December, 1952, £18.

(3) At 31st December, 1952, the rates were prepaid to the following 31st March, the yearly charge being £120. A quarter's charge for telephone is outstanding, the amount accrued being £7. Expenses accruing at 31st December, 1951, £14.

(4) At 31st December, 1951, the Buildings stood in the books at £2,000 and it is required to write off depreciation at 5 per cent per annum. Investments at 31st December, 1951, were £4,000.

It is required to prepare an Income and Expenditure Account in respect of the year ended 31st December, 1952, and a Balance Sheet as at that date.

Y. G. CLUB

INCOME AND EXPENDITURE ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 1952

Dr. *Cr.*

		£			£
To Salaries . .		410	By Subscriptions . .		450
,, Stationery . . .		72	,, Profits on Sports Meetings		310
,, Rates		120	,, Dividends received .		200
,, Telephone . . .		27			
,, Sundry Expenses [£185–£14] . .		171			
,, Depreciation of Buildings		100			
,, Surplus for year transferred to Capital Fund		54			
		£960			£960

Balance Sheet as at 31st December, 1952

	£	£		£	£
Capital Fund as at 1st Jan., 1952	6,240		Buildings as at 1st Jan., 1952	2,000	
Add Surplus of Income over Expenditure for the year ended 31st December, 1952	54		*Less* Depreciation	100	
		6,294			1,900
			Investments as at 1st Jan., 1952	4,000	
			Plus Additions	250	
Subscriptions Paid in Advance		16			4,250
Telephone accrued		7	Stock of Stationery		18
			Rates Prepaid		30
			Subscriptions in arrear		29
			Cash at Bank and in Hand		90
		£6,317			£6,317

The opening balance of the Capital Fund is—

	£
Buildings	2,000
Investments	4,000
Cash	205
Subscriptions	9
Stationery Stock	10
Rates Prepaid	30
	6,254
Less Expenses Accruing	14
Capital Fund	£6,240

The Subscriptions Account will be as follows—

Dr SUBSCRIPTIONS *Cr.*

			£				£
1952 Jan. 1	To Balance	b/d	9	1952 Dec. 31	By Cash—		
Dec. 31	,, Income and Expenditure Account		450		1951 (*a*)		8
	,, Balance (*c*)	c/d	16		1952 (*b*)		422
					1953 (*c*)		16
					,, Balance	c/d	29
			£475				£475
1953 Jan. 1	To Balance	b/d	29	1953 Jan. 1	By Balance	b/d	16

	£
(*a*) There must be £9 – £8 still owing	1
(*b*) There must be £450 – £422 still owing	28
(*c*) All in advance being in respect of 1953.	
	£29

To economize time the adjustments of beginning and end outstandings may be inserted in parentheses by the side of the amount in the Income and Expenditure Account, thus: Stationery (10 + 80 - 18) = 72; thus avoiding the opening of the account, which would appear—

Dr. STATIONERY *Cr.*

			£				£
1952 Jan. 1	To Balance (Stock)	b/d	10	1952 Dec. 31	By Income and Expenditure Account		72
Dec. 31	,, Purchases		80		,, Stock on hand	c/d	18
			£90				£90
1953 Jan. 1	To Balance (Stock)	b/d	18				

Preparation of Receipts and Payments Account from Income and Expenditure Account. Where the reverse is required, i.e. to obtain a Receipts and Payments Account from an Income and Expenditure Account, the problem will necessitate the opening of a Ledger Account to find the balancing figure of cash: e.g. if the charge from Expenses Account is £40—£5 being owing at the beginning of the period and £7 at the end of the period—the Expenses Account will appear as follows—

Dr. EXPENSES *Cr.*

19..			£	19..			£
Dec. 31	To Cash		38	Jan. 1	By Balance	b/d	5
	„ Balance	c/d	7	Dec. 31	„ Income and Expenditure Account		40
			£45				£45
				19.. Jan. 1	By Balance	b/d	7

Cash paid, therefore, is £38.

Illustration. The Income and Expenditure Account of the "Homely" Club is as follows—

INCOME AND EXPENDITURE ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 1952

Dr. *Cr.*

		£			£
To Salaries		175	By Subscriptions		200
„ General Expenses		50	„ Donations		105
„ Depreciation		30			
„ Surplus for Year		50			
		£305			£305

Adjustments were made in respect of the following—

Subscriptions for 1951 unpaid at 1st January, 1952, £20; £18 of which were received in 1952.
Subscriptions paid in advance at 1st January, 1952, £5.
Subscriptions paid in advance at 31st December, 1952, £4.
Subscriptions for 1952 unpaid at 31st December, 1952, £7.
Sundry Assets at beginning of period, £260. Sundry Assets, after depreciation, £270 at end of period.
Cash balance at 1st January, 1952, £16.

Prepare Receipts and Payments Account.

"HOMELY" CLUB

RECEIPTS AND PAYMENTS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 1952

Dr. *Cr.*

		£			£
To Opening Balance	b/d	16	By Salaries		175
„ Donations		105	„ General Expenses		50
„ Subscriptions		210	„ Sundry Assets purchased		40
			„ Closing Balance	c/d	66
		£331			£331
To Balance	b/d	66			

The cash received on account of subscriptions is found from the Subscriptions Account, which is as follows—

Dr. **SUBSCRIPTIONS** *Cr.*

1952 Jan. 1	To Balance	b/d	£ 20	1952 Jan. 1	By Balance	b/d	£ 5
Dec. 31	„ Balance, 1953, Paid in Advance	c/d	4	Dec. 31	„ Balance (1951, Unpaid)	c/d	2
	„ Income and Expenditure Account		200		„ Balance (1952, Unpaid)	c/d	7
					„ Cash Received		210
			£224				£224
1953 Jan. 1	To Balance (1951)	b/d	2	1953 Jan. 1	By Balance (1953)	b/d	4
	„ Balance (1952)	b/d	7				

The procedure, as already indicated, is reverse to the ordinary way, that is the Subscriptions Account is built up from the figures available, but instead of posting *from* Cash thereto, and hence finding the balance to transfer to Income and Expenditure Account, the latter figure is given so that one "posts" from the credit of Income and Expenditure Account back to the debit of Subscriptions Account, the resulting balance being the cash received, which is then credited to Subscriptions Account and "posted" back to the Cash Account, thus completing one of the Cash Book entries.

General Illustration. The following is a copy of the published accounts of a Trades Union. Prepare therefrom (*a*) Income and Expenditure Account, and (*b*) Balance Sheet.

BALANCE SHEET FOR THE YEAR ENDING 31ST DECEMBER, 19..

		£			£
Cash in Treasurer's Hands		35	General Purposes		2,335
Property at 1st Jan., 19..		1,632	Affiliation Fees		33
Cash at Bank at 1st Jan., 19..		8,675	Administration Expenses		241
Contributions and Fees—			Miscellaneous Expenses		69
Branch No. 3		2,431	Remitted to Branch No. 2		9
Branch No. 1		122	Legal Expenses on Purchase of Property		90
Bank Interest		289	Investments Purchased		9,000
Rents Received		85	Property to Date		2,264
Bank Overdraft		800	Cash in Treasurer's Hands		28
	£	14,069		£	14,069

The funds in the hands of Branch Secretaries—not included in the above statement—

	No. 1	No. 2
	£	£
1st January, 19..	11	3
31st December, 19..	18	11

In accordance with the principles explained, it is essential to construct the opening Statement of Affairs, i.e. assets and liabilities. The Balance Sheet produced is merely a summary of Cash and Bank transactions.

			£	£
The Assets are—				
	Cash in Treasurer's Hands			35
	Property			1,632
	Bank			8,675
	Branch: No. 1: Cash		11	
	No. 2: Cash		3	
			—	14
				10,356
The Liabilities				Nil
	Accumulated Fund at 1st January, 19..			£10,356

The accounts will therefore appear as below, the items in heavy print being opening entries. The Cash Book will be written up and posted (direct to Final Accounts, where possible, in order to save time).

Dr. CASH AND BANK ACCOUNT *Cr.*

		£			£
To Balance—			By General Purposes	I. & E.	2,335
Cash . . b/d	**S.A.**	**35**	„ Affiliation Fees	I. & E.	33
Bank . . b/d	**S.A.**	**8,675**	„ Administration Exes.	I. & E.	241
„ Contributions and Fees—			„ Miscellaneous Exes.	I. & E.	69
			„ Branch No. 2	L.	9
Branch No. 3	I. & E.	2,431	„ Legal Exes. (Property)	L. or B.S	90
Branch No. 1	L	122	„ Investments	L. or B.S	9,000
„ Bank Interest	I. & E.	289	„ Property Purchased	L. or B.S.	632
„ Rents	I. & E.	85	„ Balance: Cash . c/d	B.S.	28
„ Balance: Bank Overdraft . c/d	B.S.	800			
	£	12,437		£	12,437
To Balance: Cash . b/d		28	By Balance: Bank b/d		800

It will be advisable to show accounts for the branches—if pressed for time in examination work, merely rough working accounts will suffice.

Dr. BRANCHES *Cr.*

		No. 1	No. 2			No. 1	No. 2
		£	£			£	£
To Balances b/d	**S.A.**	**11**	**3**	By Cash	C.B.	122	
„ Cash	C.B.		9	„ Income and Expenditure Account	I & E.		1
„ Income and Expenditure Account	I. & E.	129		„ Balances c/d	B.S.	18	11
		£140	£12			£140	£12
To Balances b/d		18	11				

The other accounts may be worked through to the Balance Sheet direct, but will be given for completeness.

Dr. PROPERTY *Cr.*

		£			£
To Balance . . b/d	**S.A.**	**1,632**	By Balance . . c/d	B.S.	2,354
„ Purchase	C.B.	632			
„ Legal Expenses	C.B.	90			
		£2,354			£2,354
To Balance . . b/d		2,354			

Dr. ACCUMULATED FUND *Cr.*

			£				£
To Balance	c/d	B.S.	10,611	By Balance	b/d	S.A.	10,356
				" Income and Expenditure Account	.	I. & E.	255
		£	10,611			£	10,611
				By Balance	b/d		10,611

The abbreviations against each item indicate how the item has been dealt with and will serve to assist the student in building up the Final Accounts without using Ledger accounts, save perhaps a rough working account of the branches.

S.A. = Statement of Affairs. I. & E. = Income and Expenditure Account
L. = Ledger Account. C.B. = Cash Book.
B.S. = Balance Sheet.

The Income and Expenditure Account and Balance Sheet will now be—

INCOME AND EXPENDITURE ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 19..

Dr. *Cr.*

Expenditure			£	*Income*		£	£
To General Purposes			2,335	By Contributions and Fees—			
" Affiliation Fees			33	No. 1 Branch		129	
" Administration Expenses			241	No 3 Branch		2,431	
" Miscellaneous Expenses			69			2,560	
" Balance, being Surplus of Income over Expenditure, transferred to Accumulated Fund			255	*Less* No 2 Branch		1	2,559
				" Bank Interest			289
				" Rents			85
			£2,933				£2,933

BALANCE SHEET AS AT 31ST DECEMBER, 19..

		£	£			£	£
Accumulated Fund at 1st Jan., 19		10,356		Property: Balance at 1st Jan, 19		1,632	
Add Surplus of Income over Expenditure for the year ended 31st Dec., 19..		255		*Add* Purchase[1]		722	
			10,611				2,354
Bank Overdraft			800	Investments, at Cost (Market Value £...)			9,000
				Cash on Hand		28	
				Cash at Branches—			
				No. 1	£18		
				No. 2	11		
						29	
							57
		£	11,411			£	11,411

[1] In examination work, having accounted for the opening entries, the student will save time by using the so-called Balance Sheet of the Treasurer, which is merely a combined Cash and Bank Account, together with the

It is assumed that there are no expenses accrued or accruing either at 1st January, 19.., or at 31st December, 19...

More detail would be required as to investments, e.g. date of purchase, dividends, etc.

Receipts and Expenditure Account. An account of this nature confines the income earned to the cash received and at the same time includes *all* expenses, whether paid or not. This method is usually adopted in preparing the accounts of a business of a professional nature (e.g. doctors and solicitors) on the ground that the debtors are of a very uncertain nature, so that a fee may not be considered as earned until the cash is received. Nevertheless, the proprietor desires to ascertain what are the fees *earned* in the business so as to obtain the true profits for each period. Hence the rule is that the fees are incorporated into the accounts in the usual way just as if there were no likelihood of any of the outstandings proving bad. A 100 per cent Debtors Provision (or Reserve) is made, which reduces fees "earned" to a "cash received" basis. Alternatively a proportion of profit equalling Debtors and the completed work may be carried forward at the end of each year.

Similar treatment may be accorded to uncompleted work of a professional man.

The adjustment of the Provision is made through the Appropriation section of the Receipts and Expenditure Account so that both true profits and the fees received profits are disclosed, as circumstances may arise, necessitating the use of the true profits (e.g. on a sale of the business, introduction of a partner, and the like).

In the Balance Sheet will be shown the debtors and uncompleted work, from which will be deducted the Debtors Provision covering the full amounts thereof.

Bad Debts written off are treated in the usual way.

The rules may be summarized thus—

(1) Where there are no initial debtors create a 100 per cent Debtors Provision at the end by debiting Receipts and Expenditure Appropriation section and crediting Debtors Provision; and in future years—

(2) Debit previous year's Provision and credit Receipts and Expenditure Appropriation section; and debit the latter and credit new Debtors Provision with 100 per cent on current debtors outstanding.

---

beginning and closing Property figures; the difference between the beginning Property (£1,632) and the closing Property (£2,264) is merely the cost of the Property acquired during the year. Hence the opening Property may be inset immediately in the 31st December, 19.., Balance Sheet, and the cost of the Property acquired added thereto. This is ascertained by eliminating the Property figures from the Cash and Bank Account and substituting on the credit side thereof the difference, i.e. £2,264 − £1,632 = £632. The sum of £90 for Legal Expenses in connection with such purchase is added to the Property Account; thus, £722 is the sum of £632 plus £90.

Alternatively, the adjustment may be made through the Provision Account or through the Fees Account.

It may be observed that uncompleted work may be that performed in its very early stages, or on the other hand, work almost complete, so that a very careful estimate is required in order that the true position may be shown.

In addition, work may be COMPLETE in respect of which no bill may yet have been rendered. In these circumstances the amount of such bill, if not already entered through the books, must be treated like Debtors, whilst occasionally work may be paid for by the client in advance.

The double entry aspect is precisely the same as that relating to debtors, so that the adjustment may be made on the same lines, through (*a*) the Receipts and Expenditure Appropriation section, or (*b*) the Provision, or (*c*) Fees Account.

Illustration. The following is the Trial Balance of a professional man at the end of the first year of his business—

TRIAL BALANCE

		Dr.	*Cr.*
		£	£
Fixtures		300	
Capital			1,500
Bank		430	
Fees			1,200
Drawings		730	
Debtors.		700	
Expenses		540	
		£2,700	£2,700

Uncompleted work is £150; completed work not yet entered, £320; payments in advance by clients, £70.

Prepare accounts on the usual professional lines.

RECEIPTS AND EXPENDITURE ACCOUNT FOR THE YEAR ENDED......

Dr. *Expenditure*		£	£	£	*Receipts* *Cr.*		£	£	£
To Expenses . .				540	By Fees Earned—				
,, "Earned" Profit .	c/d			1,060	Cash Received and Debtors .		1,200		
					Add Completed Work		320		
					Uncompleted Work		150	1,670	
					Less Cash Received in Advance . .			70	
									1,600
				£1,600					£1,600
To Provision for Debtors' Completed Work .				1,020	By "Earned" Profit .	b/d			1,060
,, Provision for Uncompleted Work . .				150	,, "Cash" Loss transferred to Capital Account . .				110
				£1,170					£1,170

Balance Sheet as at..............

	£	£		£	£
Clients' Payments in Advance		70[1]	Fixtures		300
Capital Account	1,500		Debtors (as per Ledger)	700	
Less Drawings	730		*Add* Completed Work	320	
	770			1,020	
Less "Cash" Loss as per Receipts and Expenditure Account	110		*Less* Debtors Provision	1,020	nil
		660	Uncompleted Work	150	
			Less Provision	150	nil
			Bank		430
		£730			£730

Illustration. The following is the Trial Balance of X—

	Dr.	Cr.
	£	£
Debtors Provision, 1951		320
Uncompleted Work	307	
Expenses	595	
Uncompleted Work Provision, 1951		307
Work done and Charged		2,120
Capital		2,000
Sundry Assets (including Bank)	3,335	
Debtors	510	
	£4,747	£4,747

Uncompleted Work, 1952 . . . . £490
Fees Received during 1952 . . . £1,930
Bad Debts to be written off during 1952 . £120

Receipts and Expenditure Account for year ended 31st December, 1952

Dr.		£	Cr.		£
To Uncompleted Work		307	By Fees Earned		2,120
„ Expenses		595	„ Uncompleted Work		490
„ Bad Debts		120			
„ "Earned" Profit	c/d	1,588			
	£	2,610		£	2,610
To 1952 Provision—			By "Earned" Profit	b/d	1,588
Debtors		390*	„ 1951 Provision—		
Uncompleted Work		490	Debtors		320*
„ "Cash" Profit transferred to Capital Account		1,335	Uncompleted Work		307
	£	2,215		£	2,215

[1] Part of this might be absorbed in work done, and would be deducted from the total debtors, the provision being accordingly reduced; further, if the amount so received will under no circumstances be returnable, the whole £70 may be deducted from debtors and the provision reduced to £950, as the £70 portion of the debtors cannot become "bad." Depreciation ignored.

* See next page.

Balance Sheet as at 31st December, 1952

		£	£		£	£
Capital		2,000		Sundry Assets . .		3,335
Add "Cash" Profit .		1,335		Debtors . . .	390	
			3,335	*Less* Provision . .	390	nil
				Uncompleted Work .	490	
				Less Provision . .	490	nil
			£3,335			£3,335

* Alternatively the net difference may be inserted thus—

Dr. Debtors Provision *Cr.*

		£			£
To 1952 Balance . . .	c/d	390	By 1951 Balance . . .	b/d	320
			,, Income and Expenditure Account . . .		70
		£390			£390
			By 1952 Balance .	b/d	390

The Debtors Accounts are (totalled)—

Dr. Debtors *Cr.*

		£			£
To Balances . . .	b/d	320	By Cash		1,930
,, Fees Charged . . .		2,120	,, Balances . . .	c/d	510
		£2,440			£2,440
To Balances . .	b/d	510	By Bad Debts written off .		120
			,, Balances . . .	c/d	390
		£510			£510
To Balances . . .	b/d	390			

A similar procedure may be adopted in respect of the Uncompleted Work Provision.

If the uncompleted work had been incorporated in Fees Account the Receipt and Expenditure Account would be—

Dr. Receipts and Expenditure Account *Cr.*

Expenditure		£	*Receipts*		£
To Expenses		595	By Fees Account. . .		2,303
,, Bad Debts . . .		120			
,, "Earned" Profit[1] . .		1,588			
		£2,303			£2,303

[1] Corresponding with earned profit brought down on page 277.

The Fees Account would be—

Dr. FEES ACCOUNT (1952) *Cr.*

		£			£
To Uncompleted Work .	b/d	307	By Fees Charged . . .		2,120
„ Receipts and Expenditure Account . . .		2,303	„ Uncompleted Work .	c/d	490
		£2,610			£2,610
To Uncompleted Work .	b/d	490			

It should be noticed that the method adopted here is the "full" double entry, thus making the personal accounts an integral part of the double entry system, whereas in the example given on page 276 the method adopted was the "abridged" double entry; but neither method affects the "100 per cent Provision" system because the true position is properly disclosed both in the full and abridged method.

It is unusual to reduce Expenses to a cash basis by a 100 per cent Provision, but if this procedure is adopted the same principles apply, all the entries being reverse to those already outlined.

It should be clearly borne in mind that the full double entry system may be used or the abridged method, from which the true profits are ascertained, after which the necessary adjustments for Debtors and Uncompleted Work will be made.

If the full double entry is in use the Fees Accounts and Debtors will appear in the Trial Balance in the ordinary way; but in the abridged method the Cash received only will appear, the Fees and Debtors being memoranda only, so that the procedure outlined in Chapter XI must FIRST be followed prior to the creation of the 100 per cent provision.

The same principle may be adopted when the parties desire that only a proportion of Debtors be taken in as good, e.g. 50 per cent; in fact it may be repeated that once the significance of the provision is grasped, viz. that the principles applicable to ordinary Bad Debts Provisions are applicable, except that a very large rate (100 per cent or less as desired) is taken, no difficulty should be encountered.

CHAPTER XIII

TABULAR BOOK-KEEPING

THE student will have observed during the course of his practical work that, where feasible, much labour may be avoided by the judicious use of the columnar and tabular system. Wherever transactions are of a regular type and frequent in number, the system can be profitably employed; and, without being conscious of it, students meet with the method almost every day: the discount column of the Cash Book, the analysis of the Petty Cash Book, the departmental columns in the Sales Day Book, and the analysis columns in the Expenses Day Book are common examples of the employment of this system.

In all cases the principle is the same; that is, the insertion of the record of the transaction in its appropriate column and the completion of the double entry by means of the posting of the total thereof. As a rule, the student tends to become confused only when the system departs in any way from that usually met with as a matter of daily routine.

The most familiar examples of the use of the tabular system are found in the accounts of—

(1) Estate Companies for tenants' accounts.

(2) Gas, Water, and Electricity Undertakings for customers' accounts.

(3) Hotels for visitors' accounts.

(4) Insurance Companies for premiums.

In almost every business use is made of the tabular principle in order to avoid unnecessary repetition of detail, the most obvious example being the Columnar Cash Book.

In accounts relating to a regular and permanent service, such as Rents, Gas, Water, Electricity, and the like, instead of separate pages being employed for each individual customer, one or more pages are used for each period and the appropriate records made by taking one line for each CUSTOMER. The Ledger will be suitably ruled in the light of the circumstances obtaining, as for instance in Rental Ledgers the customers' names will be entered in the sequence of the numbers of their residences, thus facilitating the making of the entries, e.g. Nos. 1, 3, 5, etc., Queen's Drive. The first accounting column will contain the carry-forward from the preceding account, and will in total equal the outstanding debtors. Such a total will have appeared in the Balance Sheet in the ordinary way and differs only from the normal in that the balances on the individual accounts do not appear on separate pages. The next column on the debit side will contain the entries for charges, the

total of which will be posted to the credit of Rent, Sales of Gas, etc., or whatever the particular service comprises. The next column will be the cross total of the two debit columns. On the credit side will be columns recording cash received, allowances, and other credits, according to circumstances, the last two columns being for the carry forward of balances and for the cross totals of the credit items on each line.

The principle may be illustrated by reference to a very simple example; so simple, in fact, that the employment of the tabular method would not be considered worth while.

Illustration. Estate & Co. own four houses, Nos. 1, 3, 5, and 7 Lord Street, Northport; the tenants are respectively A, B, C, and D; the quarterly rents being £15, £23, £25, and £18 respectively. A, at the beginning of the quarter ended 29th September, 19.., owes £3. The receipts from tenants are: A, £18; B, £21 (allowance for repairs, £2); and C on account, £20. D left by arrangement on 1st September, the rent for the period of occupation being £12.

Write up the Rental Ledger and show how the double entry is effected. (See page 282.)

The double entry will be effected thus—

(1) £3 is the amount brought forward and will be part of the balances at the opening date.

(2) Total Rents will be posted to credit of Rents, £81.

(3) Totals on each side cancel each other.

(4) The debits for the Cash received will appear in the Cash Book. (A separate column may be employed in the Cash Book, the total of which should correspond with the total of the column in the Ledger.)

(5) The total will be posted to the debit of the allowance in question, and if warranted, would be further analysed; in this case the £2 will be posted to the debit of Repairs Account.

(6) The total will be posted to the debit of Rent Account.

(7) This is a balance forward to the next quarter, and will appear on the debit side on the No. 5 Lord Street line as £5.

(8) See (3) above.

Thus the "Trial Balance" of the above items is—

	Dr.	*Cr.*
	£	£
(1) Opening Balance		3
(2) Rents		81
(6) Rents	6	
(4) Cash	71	
(5) Repairs	2	
(7) End Balance	5	
	£84	£84

Dr. **RENTAL LEDGER** (See page 281) Cr.

No. of Property	Name of Tenant	Arrears Brought Forward	Quarterly Rent	Total Debits	Date of Receipt	Receipt No.	C.B. Fol.	Cash Received	Allowances	Empties	(Other Cols. as Required)	Arrears Carried Forward	Total Credits	Observations
		£	£	£				£	£	£		£	£	
1 Lord St.	A .	3	15	18				18					18	
3 ,,	B .		23	23				21	2				23	
5 ,,	C .		25	25				20				5	25	
7 ,,	D .		18	18				12		6			18	Left Sept. 1
		£3	£81	£84				£71	£2	£6		£5	£84	
		(1)	(2)	(3)				(4)	(5)	(6)		(7)	(8)	

Dr. **GAS CONSUMPTION LEDGER** (See page 283) Cr.

Number and Street	Particulars	Meter Reading		Arrears Brought Forward	Charges[1]	Total Debits	Date Received	No. of Receipt	Cash Received	Allowance	Irrecoverable	Arrears Carried Forward	Total Credits	Observations
		Cub. Ft.	Therms											
				£ s. d.	£ s. d.	£ s. d.			£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	

[1] The Charges column will, where required, be subdivided, e.g. Maintenance, Stove Hire, Meter Hire, etc.

If presented in the form of a "Total" account this would be—

Dr. TOTAL DEBTORS *Cr.*

			£				£
	To Balance . . .	b/d	3		By Cash (*Dr.* Cash) . .		71
	,, Rents (*Cr.* Rent) . .		81		,, Repairs (*Dr.* Repairs) .		2
					,, Empties (*Dr.* Rent) .		6
					,, Balance . . .	c/d	5
			£84				£84
	To Balance . . .	b/d	5				

Illustration. The following simple ruling (eliminating the detail columns) illustrates the principle of columnar book-keeping applied to the Cash Book.

Dr. CASH BOOK *Cr.*

Cash Sales	Allowances	Discount	Cash	Bank	Drawings	Commission	Rent, Rates	Discount	Cash	Bank

The receipts from Cash Sales will be entered in the cash column in the ordinary way, and inserted in the Cash Sales column, the total of which will be posted to the *credit* of Cash Sales. The allowances column (where they are settled as accounts are paid) is treated exactly like the discount column; that is, the total will be transferred to the DEBIT of allowances (the credits having been made to the customers' accounts). The other columns on the debit side require no comment.

The credit side columns of the Cash Book will, as regards Drawings, Commission, Rent, and Rates (and any other additional column), have entered in them the appropriate payment as shown in either the Cash or Bank column, and their totals will be posted to the DEBIT of the respective accounts.

Illustration. The ruling of a Gas Consumption Ledger will be as shown on page 282.

In the case of a Water Rental Ledger, the rulings will be somewhat similar, except that normally as the charge is based on Rateable Value, a column for this figure will be inserted next to the charge column, but obviously none will be required for Meter Readings, except where special arrangements exist (as in the case of works,

breweries, laundries, etc.), owing to the abnormally large consumption of water.

Visitors' Ledger. The method employed by hotels is to rule the Ledger—called the Visitors' Ledger—so that from left to right are rulings for each room, the appropriate charges for which are entered on the line against the item printed on the extreme left. Instead of the debit side being shown in the usual manner, the top portion of the folio contains the charges above-mentioned and the bottom portion the credit items, e.g. cash paid, allowances, etc. The top portion columns added vertically will therefore show the total debits for each room, which should, allowing for carrying forward of balances, equal the vertical additions of the bottom portion. The horizontal totals will represent the total charges to the rooms detailed on the folio, and will be posted to the credit of the particular account to which they refer, e.g. apartments, either directly or through the medium of an Abstract Book.

One folio is employed for each day, any balances being carried forward to the next folio.

Occasionally, as in the case of a permanent resident, it will be necessary to transfer the total at the end of each week to an ordinary Ledger Account, so that the bottom portion of the Visitors' Ledger (representing the credit side of the Ledger) will have a line for transfers.

Where necessary, e.g. owing to the large number of rooms in use, there will be several ledgers, usually subdivided on the "storey" basis, e.g. first floor, second floor, etc.

Although not strictly material to the explanation of the tabular system of book-keeping, the following matters relating to hotel accounting should be noted—

(1) Separate accounts may and certainly ought to be kept for receipts in respect of Wines, Beer, Spirits, Rooms, etc., the appropriate expenses being debited against them and the resulting balance transferred to Profit and Loss Account.

(2) Appropriate entries are necessary in respect of accommodation, Meals, Laundry, and the like, of the staff, and of the Proprietor and his family, so that the true results of each section may be correctly ascertained. The transfer will be a debit to Drawings (in the case of proprietor) or Wages (in the case of staff) and a credit to the account in question, e.g. Meals Account. Apart from these, there are frequently transfers between the various sections of the hotel, e.g. in respect of kitchen staff, who will have their overalls laundered in the hotel.

(3) Each section should be charged with a fair proportion of rent and rates, and in cases where the hotel premises are owned by the management, a charge, correctly apportioned, should be made to cover rent, and Profit and Loss Account credited.

Illustration.

VISITORS' LEDGER

Date.......... *Aug.* 1. .... 19..

	Room No. 1			Room No. 2			Room No. 3			Etc.			Total			
Dr.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	
Brought forward				5	11	0							5	11	0	Brought forward
																Posted to credit of
Apartments	4	0	0	3	10	0	2	0	0				9	10	0	Apartments
Board		5	0		10	0		10	0				1	5	0	Board
Wine								15	0					15	0	Wine
Laundry		2	6		5	0		5	0					12	6	Laundry
Minerals		5	0											5	0	Minerals
	£4	12	6	£9	16	0	£3	10	0			£	17	18	6	
Cr.																
Cash				9	16	0	3	0	0				12	16	0	Posted from debit of Cash Book
Allowances								10	0					10	0	Posted to debit of Allowances
Transfers																
Carried forward	4	12	6										[1]4	12	6	Carried forward
	£4	12	6	£9	16	0	£3	10	0			£	17	18	6	

[1] If the amount of £4 12s. 6d. is to be transferred to the ordinary ledger it would be inserted in the line above and posted to the debit of the Personal Account. The totals at the right hand of the folio (top section) might alternatively be entered in an abstract book and the total thereof posted to the credit of the relevant accounts. The Abstract Book would be ruled thus—

ABSTRACT BOOK

Date	Folio	Apartments			Board			Wine			Laundry			Minerals			Total		
19..		£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.
Aug. 1		9	10	0	1	5	0		15	0		12	6		5	0	12	7	6
2																			
3																			
Etc.																			
Etc.																			

If the above entries were shown in ordinary Ledger form the result would be—

Dr. VISITORS' LEDGER (TOTAL ACCOUNT) *Cr.*

		£	s.	d.			£	s.	d.
To Balance	Brought forward	5	11	0	By Cash	Debit Cash Book	12	16	0
,, Apartments, etc. (as detailed)	Credit Apartments, etc., Accounts	12	7	6	,, Allowances	Debit Allowances		10	0
					,, Balance	Carried forward	4	12	6
	£	17	18	6		£	17	18	6
To Balance	Brought forward	4	12	6					

The subsidiary books (e.g. the Cash Book, Invoice Book, etc.) would be analysed on the following lines—

INVOICE BOOK

Date	Name	Led. Fol	Total			Provisions			Beer, Wines, and Minerals			Cutlery, Glass, and Plate			Etc.			Etc.		
			£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.

The Cash Book is shown on page 287 (No. 1).

In order to give a clearer conception of the principle, a simple system of tabular book-keeping applicable to a medical practitioner is outlined, but it should be remembered that the working of it would require adaptation to fit in with any peculiar features of the practice in question.

The main book is the Cash Book, which is supported by total accounts in respect of each Ledger.

Illustration. The accounts are constructed as shown on page 287 (No. 2).

Debit Side. Each total is posted to the respective account; the collectors' column, being a "Total" column, will therefore be posted to the credit of Collectors' Nos. 1 and 2 Total Accounts respectively; the details making up these totals will be posted from the Collectors' Cash Received books to the credit of the patients' accounts. The "Private Patients" column is dealt with on the same lines.

Credit Side. The total cash paid will be the sum of columns (*a*) and (*d*), i.e. £6 3s. 7d. + £336 0s. 7d. = £342 4s. 2d. (thus balancing the cash received). The total payments for expenses will be the total of (*a*) and (*c*), i.e. £6 3s. 7d. + £218 17s. 2d. = £225 0s. 9d. the analysis of which will be—

	£	s.	d.
Drugs and Bottles . .	24	10	0
Sundries	29	19	3
Drawings . . .	164	7	11
Collectors' Commission .	6	3	7
	£225	0	9

These items will be posted to the appropriate accounts.

Totals (*c*) and (*d*) are the Bank items and, apart from the beginning balance, (*d*) less (*c*) equals the increase of the Bank Balance: these totals usually being debited to a separate Bank account, thus—

Dr. BANK *Cr.*

	£	s.	d.		£	s.	d.
To Receipts . .	336	0	7	By Payments . .	218	17	2

If desired, the above totals may be carried into an Abstract Book and one posting effected at the end of the accounting period.

No. 1

Dr. **Cash Book** *Cr.*

Date	Particulars	Led. Fol.	Ledger Account	Visitors' Payments	Bar and Billiards Receipts	Total	Date	Particulars	Led. Fol.	Provisions	Beer, Wines, and Minerals	Cutlery Glass, and Plate	Etc.	Total
			£ s d	£ s. d.	£ s. d.	£ s d.				£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.

No. 2

Dr. **Cash Book** *Cr.*

Date	From Whom Received	Fol.	Total Cash	Collectors 1	Collectors 2	Private	National Health Service	Box	Date	To Whom Paid	Fol.	Paid by Cash	Paid by Cheque	Paid into Bank	Drugs and Bottles	Sundries	Drawings	Collectors' Commission.
			£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.				£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.
			342 4 2	33 9 0	20 5 0	9 11 0	268 18 4	10 0 10				6 3 7	218 17 2	336 0 7	24 10 0	29 19 3	164 7 11	6 3 7
												(a)	(c)	(d)				

The Trial Balance, therefore, will be—

	£ s. d.	£ s. d.	£ s. d.
Expenses (detailed) . .		225 0 9	
Cash Service (Box) . .			10 0 10
National Health Service .			268 18 4
Private Ledger . . .			9 11 0
Collectors' Total Accounts (1)			33 9 0
,, ,, ,, (2)			20 5 0
Bank Lodgments . .	336 0 7		
Less Payments . .	218 17 2		
		117 3 5	
		£342 4 2	£342 4 2

Day Books. The Day Books will be analysed into the various Ledgers: (1), (2), and "Private"; and the totals will be posted to the debit of the appropriate Total Account, the individual postings being made to the debit of each patient and the total of the Day Book to the credit of Fees Account. If the services performed for a period were: Ledger (1) £48, Ledger (2) £120, "Private" Patients Ledger £60, the debits would be (1) in the Total Account, (2) in detail to the patients in the appropriate Ledger, and the credit to Fees Account in one figure.

Transfers. Transfers from one account to another, which may arise not only through errors, but by patients changing their residence, will be put through a Transfer Journal, the totals of which will be posted to the Total Account of the Ledger concerned and the detailed entries to the appropriate individual accounts, thus—

TRANSFER JOURNAL

Dr *Cr*

Date		Fol.	No 1 £ s d	No. 2 £ s d	Private £ s d		Fol	No 1 £ s d	No 2 £ s d	Private £ s d
	W Jones		2 0 0			R Jones			2 0 0	
	Dixon .				3 0 0	Walters .		3 0 0		
	Robinson				7 0 0	Robertson				7 0 0
			£2 0 0		£10 0 0			£3 0 0	£2 0 0	£7 0 0
			Debit of Total Accounts					Credit of Total Accounts		

By way of illustration on the above information, No. 1 Total Account would be—

Dr. NO. 1 LEDGER TOTAL ACCOUNT *Cr.*

	Fol	£ s d		Fol.	£ s. d.
To Fees (per Day Book) .		48 0 0	By Cash (per Cash Book) .		33 9 0
,, Transfer (per Transfer Journal) . .		2 0 0	,, Transfer (per Transfer Journal) . .		3 0 0
			,, Balance . . .	c/d	13 11 0
	£	50 0 0		£	50 0 0
To Balance . . .	b/d	13 11 0			

The individual ledger balances in No. 1 Ledger should therefore equal £13 11s.

The use of the tabular system in the books of an accountant is shown by the following—

Illustration. From the following tabular entries prepare a Trial Balance. (The letters in parentheses are for the guidance of the student.)

CASH BOOK

	Professional[1]	Tuition	Rent[2]	Rates[2]	Bank
	£	£	£	£	£
Total *Dr.* side	1,735 (*a*)	420 (*a*)	60 (*b*)	45 (*b*)	2,260 (*e*)

	Drawings	Expenses	Rent	Rates	Bank
	£	£	£	£	£
Total *Cr.* side	530 (*c*)	230 (*d*)	100 (*b*)	75 (*b*)	935 (*e*)

TRIAL BALANCE

	Dr.	*Cr.*
	£	£
(*a*) Fees received		2,155
(*b*) Rent net paid	40	
(*b*) Rates net paid	30	
(*c*) Drawings	530	
(*d*) Expenses	230	
(*e*) Excess of Bank lodgments over withdrawals .	1,325	
	£2,155	£2,155

Combined Day Book and Ledger. Where practicable, the employment of a combined Purchases Day Book and Ledger will save a considerable amount of time and labour.

The book is ruled in ledger form, the credit side being used for purchases and the debit for returns and payments. At a suitable date the total of the purchases will be posted to the debit of Purchases Account and the total of the returns to the credit of Returns Outwards, or of Purchases, Account. Cash and Discounts will be posted to the debit side of the book from the credit of the Cash Book in the usual way. If the settlement is by Bill, the credit will be to Bills Payable Account.

The invoices may be entered in strict date order or as they are received, but it will probably be found more convenient to file them

[1] Divided as required, e.g. Auditing, Taxation, etc.

[2] The receipts in respect of Rent and Rates indicate that part of the offices was sublet.

Combined Purchases Day Book and Ledger

Debits								Credits			
Date	Settled by	Fol.	Cash and Discount	Bill	Returns	Transfers	Total	Date	Name	Details	Total
19..			£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	19..		£ s. d.	£ s. d.
June 10	Returns . .				1 9 0			June 2	H. Laycock	17 3 0	
July 1	Cash and Disct. .		23 16 6				25 5 6	9	H. Laycock	8 2 6	
											25 5 6
2	Cash and Disct. .		37 5 0				37 5 0	12	E. Cosslett .		37 5 0
	Bill . .			100 0 0			100 0 0	17	H. Andrews		100 0 0
31	Forward .					25 0 0	25 0 0	29	A. Easton .		25 0 0
			£61 1 6	£100 0 0	£1 9 0	£25 0 0	£187 10 6				£187 10 6

in alphabetical or some other order until the end of each, say, month, when all the invoices relating to each supplier will be entered together in date order in a details column and the monthly total for each supplier carried out into the main column.

Returns may be dealt with either—

(1) in a separate column on the debit side, or

(2) as a deduction in the details column before the total is carried out, or

(3) as deductions on the invoices to which they apply, the latter being entered net in the details column.

Items which are not paid at the usual date may either be transferred into a Creditors Account in a Ledger, or preferably, by means of a special column, into the succeeding period, thus enabling both sides of the book to be totalled and agreed. If transactions are numerous, the book should be cleared at least once a month, but leaving one month open where it is the practice to settle in the month following the purchase.

Illustration. (See page 290.)

Where the settlement is always by Cash (with or without discount), the work can be further curtailed by dispensing with the debit side and having a date paid column and folio column, returns being dealt with on the credit side by method (2) or (3) above.

Illustration.

COMBINED PURCHASES DAY BOOK AND LEDGER

Date	Name	Details	Total	Date Paid	Fol.
19..		£ s. d.	£ s. d.	19..	
June 2	H. Laycock . .	17 3 0			
9	H. Laycock . .	8 2 6			
		25 5 6			
10	Returns . .	1 9 0			
			23 16 6	July 1	
12	E. Cosslett . .		37 5 0	2	
17	H. Andrews . .		100 0 0	2	
29	A. Easton . .		25 0 0	Transfer[1]	
			£186 1 6		

At the end of the financial period it is desirable to transfer ALL unpaid items to a Creditors Account in a Ledger and to debit them, when paid, in that account.

A combined Day Book and Ledger can be utilized on similar lines

[1] Transferred to a Creditors Account or carried forward into a special column in the succeeding period.

for Sales, but, unless the receipts are reasonably regular and full (apart from the fact that there may be a far greater number of sales than purchases), the method is not worth while, although it has been found that frequently it is perfectly satisfactory, particularly if

(*a*) a Total Account is prepared, say, monthly and

(*b*) unpaid items are transferred to a Debtors Account in a Ledger not later than the end of the following month, thus leaving no more than two months open, e.g. April Sales will be entered up and April and May allowed for entering the receipts. At the end of May, any unpaid items will be transferred into the Ledger.

CHAPTER XIV

CORRECTION OF ERRORS

ERRORS calling for correction arise by reason of—

- Errors in the amount posted.
- Posting to the wrong side of an account.
- Errors of additions and carry forwards.
- Posting to the incorrect account.
- Omissions in the books of original entry.

The student, particularly in the intermediate examinations of the professional accountancy bodies, is very frequently called upon to give the entries for correcting errors.

The methods vary somewhat in detail, and no rigid rule can be formulated: but the procedure outlined below is simple and effective.

(1) Deal with the amount of discrepancy of the Trial Balance by raising on the "short" side a Suspense Account.

(2) Correct the *arithmetical* error, ignoring any omission in the books of original entry and the incorrectness of the account; this will be done by entering the necessary figure on the opposite side of the Suspense Account (thus eliminating it) and a reverse entry to the account to which the original posting was made. The result is to dispose completely of the "out of balance."

(3) If necessary, next deal with the figure—now correct in *amount* but in the wrong *account*—by an ordinary transfer through the journal. This will result in giving the correct amount in the proper account.

(4) If necessary, next deal with the omission in the books of original entry by entering the omitted amount in the journal and posting in the ordinary way.

An error in addition will be dealt with in the same manner as an incorrect posting.

Some of the corrections of errors will merely affect assets and liabilities, whilst others will cause a modification of the Profit and Loss Account.

The four processes may be consolidated into one entry, but in cases of extreme complication the separate processes should be worked and either entered separately or attached to the consolidated entry by way of explanation.

Illustration. An item of £40 has been posted as £4 from the debit of the Cash Book to the credit of a customer's account. Taken alone, the obvious amount of discrepancy is £36 "short" credit.

The correction, therefore, is (using Ledger Accounts for clarity)—

Dr. SUSPENSE *Cr.*

		£	s.	d.			£	s.	d.
	To Ledger Account . (Name of customer)	36	0	0		By Error . . .	36	0	0

Dr. CUSTOMER *Cr.*

							£	s.	d.
					By Suspense Account	.	36	0	0

The above is a simple example and illustrates the position where there is merely *one* error of arithmetic, that is where no error has arisen either in the books of original entry or in the correctness of the account. As will be seen from rule 2, the necessary figure is *debited* to Suspense Account in order to eliminate it and credited to the account to which the original posting was made. No further adjustment is required, the correction merely affecting assets and not the Profit and Loss Account. The rules applied are 1 and 2.

The following illustrates the position where there is a double error—one of arithmetic and one of posting to an incorrect account.

Illustration. A sale of £30 was made to X and entered correctly in the Sales Day Book, but posted to the debit of Y as £3.

The position, dealing with the arithmetical error, is that sales includes a sum of £30, but the debit therefor is £3 only, thus disclosing a "short" debit (or "over" credit) of £27, this being the amount for the *debit* to Suspense Account (Rule 1). The next entry is to debit Y with £27 and credit the same amount to Suspense Account (Rule 2). The effect is to correct the arithmetic, but it still leaves the corrected amount in the wrong account: hence a Journal transfer is required by which X is debited and Y credited with £30 (Rule 3). The above correction, again, does not affect the Profit and Loss Account.

Where, however, the original entry is incorrect it is necessary, in addition, to apply Rule 4.

Illustration. If the amount of sale to Y (using similar circumstances to those in the preceding example) had been £50 and entered as £30 only, the same procedure would be employed; and, in addition, a Journal entry would be finally made to correct the omission in the book of original entry, viz., debit Y £20; credit sales £20. This applies Rule 4 and augments the sales and, therefore, profits by £20.

Having obtained a grasp of these principles, the student will be in a position to apply them to all questions dealing with correction of errors which are usually considerably more involved than those outlined above, as they may require the correction of numerous errors.

The following are illustrations of typical questions—

Illustration. The Returns Inwards Book includes an item of £7 6s. 0d., which has been posted to the debit of a customer. Correct the error.

The Returns Inwards (debit) includes £7 6s. 0d., but the posting should have been made to the *credit* of the person returning the goods (credit supplier), hence there are, in effect, two debits and no credits, totalling £14 12s. 0d. Suspense Account will, therefore,

be credited with £14 12s. 0d. The Suspense Account must then be debited and the Personal Account credited with £14 12s. 0d., thus correcting the error.

Dr. SUSPENSE *Cr.*

		£	s.	d.			£	s.	d.
	To Customer (Correction of error) .	14	12	0		By Error	14	12	0

Dr. CUSTOMER *Cr.*

		£	s.	d.			£	s.	d.
	To Returns Inwards .	7	6	0		By Suspense Account .	14	12	0

Thus, the customer is in *credit* for £7 6s. 0d., represented by the debit of £7 6s. 0d in Returns Inwards (or Sales) Account.

Illustration. An item of Purchases of £150 is entered in the Purchases Day Book as £15 and posted to the debit of the supplier's account as £51. (Perhaps an exaggerated and preposterous supposition, but many of the examination problems postulate errors even more unlikely and fanciful.) Correct the error.

As the working is likely to cause a student embarrassment, each step may be taken separately. The more advanced student will proceed to make the corrections without the subjoined detailed processes.

Rule 1. The Suspense Account, which merely deals, as has been noticed already, with arithmetical errors arising in the double entry book-keeping, is found by visualizing the actual posting, viz. Purchases £15 debit, and Supplier's Account £51 debit, this being the book-keeper's attempt at double entry. Hence, there is £66 debit and no credit, so that the Suspense Account must be created in credit for £66.

Rule 2. The Suspense Account must be eliminated by debiting it (to cancel the credit raised) with £66 and crediting Supplier's Account. The effect now obtained is that the error in balancing has been corrected and the supplier's account is in credit for £15, which is correct so far as the double entry books show.

Rule 4. As the original entry should have been £150, it is necessary to book a further £135 through the Journal and post in the usual way.

Dr. SUSPENSE *Cr.*

		£	s.	d.			£	s.	d.
	To Supplier—Correction of Error	66	0	0		By Error	66	0	0

Dr. SUPPLIER *Cr.*

		£	s.	d.			£	s.	d.
	To Purchases . . .	51	0	0		By Suspense Account .	66	0	0
						„ Purchases[1] . .	135	0	0

[1] This item will be posted to the debit of Purchases Account from the Journal.

The Supplier's Account is now in credit for £150.

Illustration. A trader effects a sale of furniture, realizing £33 16s. The amount is entered to the debit of Cash as £23 1s. 6d. and posted to the debit of Repairs Account as £32 1s. 6d. Correct the error, employing Ledger Accounts.

Dr. SUSPENSE *Cr.*

		£	s.	d.		£	s.	d.
	To Repairs Account—Correction of Error	55	3	0	By Error . . .	55	3	0

Dr. REPAIRS *Cr.*

			£	s.	d.			£	s.	d.
	To Cash . . .		32	1	6	By Suspense Account .		55	3	0
	„ Transfer to Furniture Account . .		23	1	6					
		£	55	3	0		£	55	3	0

Dr. FURNITURE *Cr.*

		£	s.	d.		£	s.	d.
	To Profit on Realization[2]		?		By Transfer from Repairs Account[1] . .	23	1	6
					„ Cash . . .	10	14	6
					„ Depreciation . .		?	
					„ Loss on Realization[2]		?	

Dr. CASH BOOK (*includes*) *Cr.*

		£	s.	d.				
	To Sale of Furniture .	23	1	6				
	„ „ „ .	10	14	6				

Examples will now be given illustrative of the treatment of several errors contained in a Trial Balance.

Illustration. The following errors are discovered in the books of a trader, the Trial Balance containing a Difference in Balance Account—

(1) Discount allowed to customers was correctly posted to the personal accounts, but the discount column in the Cash Book was over-added by £15.

(2) The Purchases Book additions for December were added and posted as £22,176, but should have been £22,426.

[1] Alternatively, the Suspense Account could be cleared by debiting it with £55 3s., crediting Repairs with £32 1s. 6d. and Furniture £23 1s. 6d., thus avoiding the transfer from Repairs to Furniture.

[2] The *book* value is not given and the above entries formally correct the error, yet it is necessary to note the probable loss or possible profit on Realization, as well as Depreciation. This may be described as a consequential entry, which is of vital importance, notwithstanding that no mention of it is made in the question itself.

(3) Goods returned (£10 8s. 4d.) by J. Jones had not been posted to his account from the Returns Book and the credit side of his Ledger Account had been over-added by £5 10s. 0d.

(4) A cheque (£21) received from X Y in settlement of his account had been returned dishonoured, and posted to the debit of Allowances Account.

Give the amount of discrepancy in the Difference in Balance Account and state how you would rectify the above errors.

The difference will be made up as follows—

	Dr £	s.	d.	Cr. £	s.	d.
(1) Excess debit of	15	0	0			
(2) Short debit (or excess credit) .				250	0	0
(3) Short credit (or excess debit) .	10	8	4			
Short debit (or excess credit) .				5	10	0
(4) No arithmetical error . . .						
	25	8	4	255	10	0
∴ Amount to be inserted in Difference in Balance Account to make Trial Balance agree . . .	230	1	8			
	£255	10	0	£255	10	0

Dr. DIFFERENCE IN BALANCE (OR SUSPENSE) Cr.

		£	s.	d.			£	s.	d.
To Balance . . .		230	1	8	By Purchases . .	(c)	250	0	0
,, Discounts Allowed	(a)	15	0	0	,, J. Jones . .	(d)	5	10	0
,, J. Jones . .	(b)	10	8	4					
		£255	10	0			£255	10	0

As to (4), X Y's account will be debited with £21 and Allowances Account credited by Journal entry.

Notes. (a) Discount Allowed Account will be credited to cancel the excessive *debit*.

(b) Jones's account will be credited with the Returns previously omitted from being posted to his credit.

(c) Purchases Account will be debited as the original posting to the debit of Purchases should have been £250 more.

(d) Jones's account will be debited with £5 10s. 0d. for the over-credit.

The Profit and Loss Account will benefit by (1) £15, and (4) £21, but will suffer by (2) £250.

It may eventually be necessary to write off the whole or part of X Y's account, and this possibility should be noted in the answer to the question.

After a student has gained proficiency in this type of question he will be able to perform the correcting entries first from which he can ascertain the original difference; that is, in reference to the

above illustration, entries (*a*), (*b*), (*c*) and (*d*) would be made, the balancing item of £230 1s. 8d. (debit) in Difference in Balance Account being ascertained at sight.

Illustration. The book-keeper of a firm having been unable to agree the Trial Balance, raised a Suspense Account in which he entered the amount by which he was out of balance. The following errors were discovered—

(*a*) The addition of the analysis column in the tabular Purchases Journal posted to Goods Purchased for Resale Account was found to be £15 short, though the addition of the total column was correct.

(*b*) Goods bought from a supplier amounting to £7 7s. 0d. had been posted to the credit of his account as £77.

(*c*) A dishonoured Bill of Exchange receivable for £160 returned to the firm's bank had been credited to the Bank Account and debited to Bills Receivable Account. A cheque was received later from the customer for £160 and duly paid.

(*d*) An item of £8 entered in the Sales Returns Book had been posted to the debit of the customer who returned the goods.

(*e*) Sundry items of plant sold, amounting to £300, had been entered in the Sales Day Book, the total of which book had been posted to the credit of Sales Account.

(*f*) An amount of £80, owing by a customer, had been omitted from the list of Sundry Debtors.

(*g*) Discount amounting to £3, allowed to a customer, had been duly entered in his account, but not posted to the Discount Account.

(*h*) An amount of £10, being rates treated as paid in advance in the previous year, had not been brought forward as a balance on the Rates Account.

(1) Show the Suspense Account as raised by the book-keeper, with the adjusting entries you would find it necessary to make therein, and

(2) Explain what effect any of the corrections would have on the profit shown in the unrectified accounts.

Dr. SUSPENSE *Cr.*

	£	s.	d.		£	s.
To Difference in Trial Balance	161	13	0	By (*a*) Goods purchased for Resale Account	15	0
,, (*d*) Customer's Account	16	0	0	,, (*b*) Supplier's Account	69	13
				,, (*f*) Debtors' Account	80	0
				,, (*g*) Discount Allowed Account	3	0
				,, (*h*) Rates Account	10	0
	£177	13	0		£177	13

Subject to (*e*) in respect of which Depreciation and Profit or Loss on Sale would be written off the book value of the plant sold, the above corrections reduce the profit by £328, made up as follows—

	£
(*a*)	15
(*e*)	300
(*g*)	3
(*h*)	10
	£328

As to (*c*) a Journal transfer will be required to debit the defaulting Acceptor's Account and credit Bills Receivable.

As to (*e*) a transfer will be required to debit Sales Account and credit Plant—together with any adjustment, as above indicated.

As to (*f*) there will be no actual posting as the omitted balance will be incorporated in the list of debtor balances.

In preceding examples the Ledger Accounts have been constructed for the purpose of clarity, from which the Journal entries may be easily written up. The following examples are appended showing the rectifying entries in Journal form.

Illustration. You are presented with a Trial Balance showing a difference which has been carried to Suspense Account, and the following errors are revealed—

(1) £35 paid in cash for a typewriter was charged to Office Expenses Account.

(2) Goods amounting to £66 sold to White were correctly entered in the Sales Book but posted to White's account as £76. The total sales for the month were overcast by £10.

(3) A cash sale of £15 to Brown, correctly entered in the Cash Book, was posted to the credit of Brown's personal account in the Sales Ledger.

(4) Goods £13, returned by Green, were entered in the Sales Book and posted therefrom to the credit of Green's personal account.

(5) Goods invoiced at £124, and debited on 20th December to Black, were returned by him on the 23rd and taken into stock on 31st December, no entries being made in the books.

(6) Sales Returns Book was overcast by £100, and the total of a folio in the same book, £1,730, carried forward as £1,703.

(7) Goods £200, purchased from Robertson on 28th December, had been entered in the Purchases Book and credited to him, but were not delivered till 5th January; stock being taken by the purchaser on 31st December.

(8) Bill Receivable from H. Jones £160, posted to the credit of Bills Payable Account and credited to H. Jones.

Journalize the necessary corrections.

JOURNAL

	£	£
1. Office Furniture . . . . *Dr.*	35	
To Office Expenses		35
Being cost of typewriter incorrectly debited to Office Expenses.		
2. *Assuming the posting made to the* **correct side** *of White's Account*—		
(*a*) Sales . . . . *Dr.*	10	
To Suspense		10
Being correction of £10 over addition in Sales Day Book.		
(*b*) Suspense . . . . *Dr.*	10	
To White		10
Being correction of posting of £66 as £76 to debit of White's Account		
3. Brown . . . . *Dr.*	15	
To Sales		15
Being correction of entry of Cash Sale posted to credit of Brown's Account.		
4. Sales . . . . *Dr.*	13	
Sales Returns . . . . *Dr.*	13	
To Suspense		26
Being correction of Returns by Green entered as Sales inadvertently for Sales Returns.		
5. Sales Returns . . . . *Dr.*	124	
To Black		124
Being Goods returned by Black unentered and included in Stock.		
6. Suspense. . . . . *Dr.*	73	
To Sales Returns		73
Being correction of errors in Sales Returns Book, viz.—		
(*a*) Excessive addition £100		
(*b*) *Less* short carry forward . . . 27		
£73		
7. (*a*) *If the title in the Goods has passed at the end of the financial year*—		
Stock in Transit . . . . *Dr.*	200	
To Trading Account		200
Being Goods purchased in the hands of Robertson.		
(*b*) *If the title in the Goods has* **not** *passed*—		
Robertson . . . . *Dr.*	200	
To Purchases		200
Being cancellation of purchase of goods entry in respect of goods purchased on 5th January, 19.. (following year).		
8. Bills Payable . . . . *Dr.*	160	
Bills Receivable . . . . *Dr.*	160	
To Suspense		320
Being correction of bill entered in Bills Payable Account instead of Bills Receivable Account.		

Where sectional balancing is in operation it will be necessary to make adjustments in the total accounts so that there will be no disturbance of the agreement of the totals with the sum of the individual Ledger balances.

Illustration. (1) A Bill Receivable was accepted by Johnson for £350 and entered in the account of Johnson as £305.

(2) Goods sold to Williamson for £100 were posted to Williams's

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		£	£
(1)	Suspense . . . . *Dr.*	45	
	To Johnson		45
	Being correction of posting to the credit of his account as £305 instead of £350.		
(2)	Williamson . . . . *Dr.*	100	
	Suspense . . . . *Dr.*	35	
	To Williams		135
	Being correction of error of goods sold to Williamson for £100 entered against Williams as £135.		

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		£	£
(1)	No correcting entry is required in the Total Accounts, since the only error is the incorrect figure on the credit side of Johnson's account. The original entries, from which the Total Accounts are prepared, are apparently correct.		
(2)	Nominal Ledger Adjustment Account . . *Dr.* [in No. 2 Ledger]	100	
	To No. 2 Sales Ledger Adjustment Account . . [in Nominal Ledger]		100
	Being adjustment of Total Accounts in respect of cancellation of debit incorrectly made to Williams's Account.		
	No. 1 Sales Ledger Adjustment Account . . *Dr.* [in Nominal Ledger]	100	
	To Nominal Ledger Adjustment Account . . [in No. 1 Sales Ledger]		100
	Being adjustment of Total Accounts in respect of sales of £100 to Williamson not debited to him.		
	Note: As in (1), no correcting entry is required in the Total Accounts for the £35 error, since the original entry in the Day Book from which the Total Accounts are compiled showed the correct figure of £100. The Total Accounts are, however, affected by the inter-Ledger transfer, since the original entry was carried out into the wrong analysis column in the Day Book. Had the original entry been carried out into No. 1 Ledger (i.e. Williamson's Ledger) analysis column, none of the above Journal entries affecting the Adjustment Accounts would be required.		

Account as £135, the £100 in the Sales Day Book having been carried out into the No. 2 Ledger analysis column.

Total Ledger Accounts were employed, Johnson and Williamson Ledger Accounts being in No. 1 Ledger and Williams in No. 2 Ledger.

Assuming that both Nominal Ledger and Sales Ledger Adjustment Accounts are employed, the Journal entries for the adjustment of the Personal Accounts and the Total Accounts are as shown on page 301.

The entries are simple if it is remembered that the amounts entered *in* the Sales Ledger Adjustment Account (in the Nominal Ledger) will correspond to the side in which the individual entry is made in the Sales Ledger, the entry *in* the Nominal Ledger Adjustment Account (in the Sales Ledger) being reverse, e.g. taking the entry to Williamson: as his account in the above adjustment is debited with £100, so must the No. 1 Sales Ledger Adjustment Account *in* the Nominal Ledger and the reverse entry be made to Nominal Ledger Adjustment Account *in* No. 1 Sales Ledger.

In all probability the total accounts may contain the correct TOTALS, so that the "total" entries above are not required, the personal account adjustments—apart from other errors—effecting the agreement with the amount disclosed in the Total Accounts.

Entry (2) has been consolidated in substitution for the longer process, viz.—

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			£	£
Suspense . . . . Dr.			35	
To Williams				35
Williamson . . . . Dr.			100	
To Williams				100

Illustration. X keeps two Sales Ledgers, employing an Adjustment Account for each Ledger. ***The Double Entry is built up from the totals of each book of Prime Entry.*** You discover that—

(1) The balance due by Jones, £20, has been transferred, owing to removal, direct from Ledger 1 to Ledger 2.

(2) £15 Cash received from Williamson (Ledger 1) not posted to his Personal Account.

(3) Sales Returns (Ledger 2) under-added, £10.

(4) A Bill Receivable £100 from Ronald & Co. (Ledger 2) entered as cash from debtors and posted to the credit of Bills Receivable.

Show what differences will be found in the Sales Ledger Adjustment Accounts and Trial Balance, and how the errors would be corrected.

(1) The transfer will affect the ADJUSTMENT accounts (assuming the items appear on the *same* sides as in Ledgers 1 and 2 respectively) as follows—

The amount of £20 must be credited to No. 1 Sales Ledger Adjustment Account and debited to No. 2 Sales Ledger Adjustment Account. This being merely a transfer from one Ledger to another, the Trial Balance will not have been influenced as regards total agreement because in fact the TOTAL balances will be correct, but there will be a disagreement between the Schedule of Debtors of each Ledger and the total shown by each of the Sales Ledger Adjustment Accounts.

(2) This sum will have been duly included in the total posted to the credit of Sales Ledger Adjustment Account so that the Trial Balance agreement is again undisturbed; but there will be a discrepancy between the Schedule of Debtors and the balance of No. 1 Sales Ledger Adjustment Account, the former being £15 in excess of the latter.

As the Ledger Accounts are here treated as "Memoranda" (the Adjustment Accounts showing the true position), no Suspense Account will be opened, the adjustment being made by posting the unposted item.

(3) The total to the debit of Sales Returns will be the same as that posted to the credit of the Sales Ledger Adjustment Account so that the effect is to create a discrepancy between the Schedule of Debtors and the total, this having no effect on the agreement of the Trial Balance; but as the total is incorrect, it will become necessary to adjust as follows—

Debit Sales Returns, £10 Credit No. 2 Ledger Adjustment Account, £10

(4) The amount of £100 being entered amongst Receipts from Debtors, will have been included in the postings to the credit of No. 2 Sales Ledger Adjustment Account as well as to the credit of Bills Receivable, and thus there are two credits: (1) in No. 2 Sales Ledger Adjustment Account, and (2) in Bills Receivable, whilst at the same time the Schedule of Debtors will not agree with the total because the debtor has not been credited with the bill £100.

The adjusting entries would be—

Debit Bills Receivable	£100	Credit Suspense Account	£100
" " "	£100	Credit cash . .	£100

Having corrected the out-of-balance and cancelled thereby the erroneous credit, it is necessary to post £100 to the credit of Ronald & Co. (the amount already having been included in the credits to No. 2 Sales Ledger Adjustment Account).

The above Adjustment Accounts will appear in the Nominal Ledger.

If an Adjustment Account were raised *in* each Sales Ledger, there would be entries therein reverse to those appearing in the Adjustment Accounts in the Nominal Ledger.

CHAPTER XV

ROYALTY ACCOUNTS

ROYALTY is the remuneration payable to a person in respect of the use of an asset, whether hired or purchased from such person, calculated by reference to and varying with quantities produced or sold as a result of the use of such asset. The expression used in a broad sense has a more extended meaning as it is frequently employed in connection with hiring of machines where the charge, instead of being upon a fixed base, say, £5 per machine, is calculated on the number of revolutions, or in textile machinery, the number of stitches.

The chief forms of royalty are Mining Royalties,[1] Patent Royalties, and Copyright Royalties, based respectively upon ore raised, products sold, and books sold. There are many other varieties, but the examination candidate's attention may be confined to those above mentioned.

In the case of Mining and similar Royalties, a considerable time must elapse before production can commence on a commercial scale, whilst similarly in the other instances considerable time must pass before sales can take place, e.g. when a lengthy advertising campaign is undertaken. In order to afford some reward during this intervening period to the lessor, inventor, or author, whilst avoiding hardship to the producer, an arrangement is usually entered into whereby the former is guaranteed a MINIMUM sum—designated Minimum Rent—usually accompanied by a proviso that if the sum due, calculated at so much per unit (e.g. ton of ore raised) does not reach the minimum, such deficiency may be carried forward, and deducted from future royalties. Such deduction may not be made indiscriminately because it is so limited that the recipient of the royalty at least receives the minimum rent. Such an arrangement is known as a **right to recoup short workings.** Where no such right exists on the part of the user, the deduction is not allowed.

In certain circumstances a minimum rent is not payable, but merely the royalty, so that the question of short workings does not arise, the payment made being calculated on quantities, e.g. tons of ore raised and charged up each year against production, whilst the recipient takes his chance as to the amount he will receive without being guaranteed any minimum periodic sum.

Another question arises in connection with the minimum rent. Even if the right to recoup short workings exists it may be either

[1] Acquisition of Coal Mining Royalties by the State and nationalization of the coal mines has rendered obsolete *Coal* Mining Royalties so far as the United Kingdom is concerned, but other mining royalties still exist, e.g. the mines in Cornwall

unlimited or limited as to time; in the latter instance the time for recoupment may be calculated from the commencement of the AGREEMENT or from the year (or other period) during which the deficiency arose.

The above-mentioned alternatives may be stated thus—

The royalty owner may receive—

1. Royalty without any minimum rent.
2. Royalty with a minimum rent.

(*a*) *With* the right of the other party to recoup short workings
  (i) recoupable without any limitation of time;
  (ii) recoupable, but within a limited time
    either (α) to a certain period commencing with the agreement;
    or (β) to a certain period from the year of deficiency.

(*b*) *Without* the right of the other party to recoup short workings.

Illustration. A landlord granted a lease to a mining company whereby he is to receive 1s. per ton of ore raised.

The output for the first three years is—

1st Year . . .	10,000 tons	3rd Year . .	24,000 tons
2nd ,, . . .	20,000 ,,		

In case 1 the landlord will receive in the first year £500, the second year £1,000, and the third year £1,200; total, £2,700.

In case 2 (*a*) (i) (assuming a minimum of £800) the landlord will receive £800 in the first year, but as this is £300 more than he would otherwise receive, the latter is recoupable in future years. He will receive in the second year £1,000, less £200, i.e. £800. The reason why the whole sum of £300 cannot be deducted is that the landlord must receive *at least* £800. This leaves the sum of £100 to be carried forward. The landlord in the third year will receive £1,200, less £100, i.e. £1,100. Students, in a case of this sort, must be careful to avoid the error of deducting from the £1,200 the sum of £400 to leave the landlord with £800, because the landlord is not restricted to £800—it is a minimum, not a maximum—after the short workings have been absorbed. It will be perceived that in the future years when output has fully developed, there is every probability that the temporary overpayments (i.e. short workings) will be eliminated, leaving in the long run the same amount of royalties as if no minimum had been bargained for. Thus, the landlord receives (comparing the two methods so far illustrated)—

	1	2 (*a*) (i)
	£	£
1st Year . .	500	800
2nd ,,	1,000	800
3rd ,, ...	1,200	1,100
	£2,700	£2,700

2 (*a*) (ii) (α). If the limitation is for two years from the commencement of the lease, the short workings at the end of the second year, i.e. £100, will be no longer recoupable and must be written

off, so that in the third year the landlord suffers no deduction and therefore receives £1,200.

2 (*a*) (ii) (*β*). If the limitation is for one year after the deficiency arises, the amount short in the first year will be recoupable only in the second year, that of the second year in the third year, that of the third year in the fourth year, and so on. Thus, the £300 short in the first year is available for the second year, but only £200 can be utilized therein (because the landlord must receive his minimum of £800), so that the sum of £100 is now irrecoverable, the landlord receiving £1,200 in the third year. Whatever the royalties in the fourth year, the landlord will suffer no deduction because in the third year there is no shortage, and it is only the third year shortage that is available for the fourth year.

2 (*b*). In this case the landlord receives in any one year the amount of royalties or his minimum rent, whichever be the LARGER. The landlord thus receives, 1st Year, £800 (Minimum); 2nd Year, £1,000 (Royalty); 3rd Year, £1,200 (Royalty).

Income Tax. It is the duty of the payer in the case of Patent Royalties, Mining Royalties, and in certain circumstances Copyright Royalties, to deduct income tax, and account for such deduction to the Inland Revenue authorities.

Such a deduction obviously in no way affects the amount of charge for royalties, as the amount of tax is merely accounted for to the Inland Revenue instead of being paid to the royalty owner. (See Chapter XXI.)

Book-keeping Entries

1. Where no minimum rent exists—

For Royalty:
Debit Royalty   Credit Landlord[1] (or Royalty owner)
For Payment:
Debit Landlord   Credit Cash[2]
Income Tax (at current rate)

2. (*a*). Where a minimum rent exists *with* right to recoup short workings. (This applies in *all* the sub-headings of (2) as the distinctions explained under this head do not affect the type of entry required.)

(i) Where the royalty is *less* than the minimum rent—

Debit Royalty (for Royalty) . . } Credit Landlord with Minimum Rent
„ Short Workings (for Deficiency) }

The amount of royalties is transferred to Production Account whilst the short workings is carried forward and shown in the Balance Sheet as an asset.

(ii) Where the royalty *exceeds* the minimum rent.

Debit Royalty (for Royalty)   Credit Landlord (for Royalty)

[1] The word Landlord will be used in the remainder of the entries outlined.
[2] As this is an ordinary book-keeping entry, it is not repeated in the remainder of the entries outlined.

with the following consequential entry IF there is ALREADY a balance on short workings.

Debit Landlord to the extent of short workings, but limited if necessary so as to leave the Landlord's balance in credit for his minimum rent	Credit Short Workings

[It will be clear that no such consequential entry can arise in the first year, unless the agreement provides therefor, as there is no balance on short workings.]

The latter entry may or may not be available, according as to whether the time limit (if any) has expired. When the right to recoup has expired the amount should be written off thus—

Debit Short Workings Irrecoverable	Credit Short Workings

As before, Royalty Account is subsequently transferred to the debit of Production Account, but the Short Workings Irrecoverable Account is transferred to the debit of Profit and Loss Account.

It may be noted that in two instances it may be desirable to write off at least a portion of the short workings even before they prove irrecoverable, viz.—

(*a*) When production in the future is not likely to be of sufficient magnitude to absorb the Short Workings Account, and

(*b*) When the lease is nearing expiry, because there will not be the opportunity to recoup in the future, as production will cease with the expiry of the lease.

2 (*b*). Where there is a minimum rent but *without* right to recoup short workings.

Where the Royalty *exceeds* the Minimum Rent:

Debit Royalty (for Royalty)	Credit Landlord (for Royalty)

Where the Royalty *is less than* the Minimum Rent:

Debit Royalty (for Royalty)	Credit Landlord (for Minimum Rent)
,, [1] Short Workings Irrecoverable (for Deficiency)	

It will be seen, therefore, that there is no difference between 2 (*a*) and 2 (*b*) except that in the latter case there is no transfer against the landlord for recoupment of short workings and the short workings are immediately written off, whilst in (1) the question of short workings does not arise, so that all the principles may be elucidated by explanatory examples of entries arising in 2 (*a*).

Illustration. The Everbrite Tin Co. obtains a lease of land from Lord X, the terms being a royalty of 2s. a ton raised with a minimum rent of £200; with a right to recoup short workings.

In the first year 1,600 tons were raised. Show Accounts in the Lessee's books.

[1] This account would have been carried forward had the right to recoup existed.

The Ledger Accounts will be—

Dr.		ROYALTY			*Cr.*
		£			£
To Lord X.		160	By Production Account.		160

Dr.		SHORT WORKINGS			*Cr.*
		£			£
To Lord X [1]		40			

Dr.		LORD X (LANDLORD)			*Cr.*
		£			£
To Cash		110	By Royalty [3]		160
,, Income Tax [2]		90	,, Short Workings [3]		40
		£200			£200

Illustration. The same terms as in the preceding illustration, the tons raised in the succeeding years being—

	Tons		Tons
Year 2	950	Year 4	3,800
Year 3	1,100	Year 5	2,600

Show Accounts in the Lessee's books.

The entries (shown in tabular form) will be—

	Royalty		Landlord		Short Workings	
	Dr.	*Cr.*	*Dr.*	*Cr.*	*Dr.*	*Cr.*
	£	£	£	£	£	£
Year 1 (repeated for sake of clarity)	160			200	40	
,, 2	95			200	105	
,, 3	110			200	90	
,, 4	380		(*a*) 180	380		(*a*) 180
,, 5	260		(*b*) 55	260		(*b*) 55
	[Total £1,005]		Total net credit [£1,005]			
	[4]		[5]		[6]	

Notes. (*a*) The most that can be transferred is £180, because if the whole of the Short Workings Account were transferred it would reduce the landlord's sum to less than £200.

(*b*) There is a balance only of £55 on short workings at the end of the fourth year, so that in the fifth year it can be wholly absorbed (still leaving the landlord with £205). Care must be taken to avoid transferring £60, as the landlord is always entitled to at least £200; and where the royalty exceeds that sum he is entitled to the excess when the short workings are exhausted, as in the fifth year.

[1] Shown in Balance Sheet as an asset, but see page 312 for alternative treatment resulting from *C.I.R.* v. *Cranford Ironstone Co.*

[2] 9s. in the £ on £200.

[3] Making up the minimum rent of £200.

[4] Transferred to Production Account.

[5] Discharged in Cash and Tax.

[6] Shown in Balance Sheet as an asset so long as available for recoupment.

It will be seen that total royalties are £1,005, whilst the landlord receives in all the same amount.

Illustration. The same facts as in the preceding illustration, except that the right to recoup short workings endures for four years, commencing with the date of the lease—or more properly for three years after the expiry of the first year of the working (i.e. all short workings must be written off unless recouped by the end of the fourth year), and that the output in the sixth year is 1,800 tons.

In this case the entries in respect of the first three years will be identical with those shown above.

The remaining entries will be—

	Royalty		Landlord		Short Workings		Short Workings Irrecoverable	
Year	*Dr.*	*Cr.*	*Dr.*	*Cr*	*Dr*	*Cr.*	*Dr.*	*Cr.*
	£	£	£	£	£	£	£	£
4 . . .	380		(a) 180	380	235[1]	(a) 180 (b) 55	(b) 55[2]	
5 . . .	260			260				
6 . . .	180			200			20[2]	

Illustration. Assuming that the lease permitted short workings to be recouped within two years from the year of the DEFICIENCY the entries, in tabular form, will be—

Year	Royalty		Landlord		Short Workings		Short Workings Irrecoverable		Notes
	Dr.	*Cr*	*Dr.*	*Cr.*	*Dr.*	*Cr*	*Dr*	*Cr*	
	£	£	£	£	£	£	£	£	
1	160			200	40				
2	95			200	105				
3	110			200	90	40	40		Year 1 Deficiency now irrecoverable
4	380		180	380		180			Year 2 Deficiency completely recouped plus £75 of year 3
	260		15	260		15			Year 3 Balance recouped
	[Total £1,005]		[Total Net Credit £1,045]				[Total £40]		

As a variation from those already treated, the following example applies the same principles to the case of royalties based on stitches made by a machine employed under a hiring agreement.

Illustration. A. S. Lacker, on 1st January, 19.., leases a machine to H. Ardy on terms that the charge for royalty be 3d. per

[1] This is the balance of Short Workings Account from the third year.
[2] Written off to Profit and Loss Account.

1,000 stitches with a minimum monthly payment of £10, with right to recoup "short workings" over the three months immediately succeeding the month of the shortage.

From the special counters employed, the numbers of stitches for each month are—

19..	Stitches	19..	Stitches
Jan. . . .	400,000	May . . .	1,040,000
Feb. . . .	640,000	June . . .	800,000
Mar. . . .	800,000	July . . .	1,200,000
Apr. . . .	960,000		

Show the entries required in the books of H. Ardy.

The entries, in tabular form, will be—

Date	Royalty		A. S. Lacker		Short Workings		Short Workings Irrecoverable		Notes
19..	Dr. £	Cr £	Dr. £	Cr £	Dr. £	Cr. £	Dr. £	Cr. £	
Jan. 31	5			10	5				Short Workings recoverable until 30th April
Feb. 28	8			10	2				
Mar. 31	10			10					
Apr. 30	12		2	12		2 3	3		£2 of the January Short Workings recouped. The balance is now irrecoverable. February Short Workings recouped in May
May 31	13		2	13		2			
June 30	10			10					
July 31	15			15					
	[Total	£73]	[Total net	credit £76]			[Total	£3]	

The full accounts will present no difficulty, but for sake of clarity the April accounts are shown below—

Dr. ROYALTY *Cr.*

19..		£	19..		£
Apr. 30	To Lacker .	12		(Total of Account transferred to Production Account)	

Dr. A. S. LACKER *Cr.*

19..		£	19..		£
Apr. 30	To Short Workings	2	Apr. 30	By Royalty .	12
	,, Cash . .	10			
		£12			£12

Dr.					Short Workings		*Cr.*
19..			£	19..			£
Apr. 1	To Balance .	b/d	7	Apr. 30	By Lacker — Short Workings recouped .		2
					,, Profit and Loss Account: Short Workings irrecoverable .		3
					,, Balance .	c/d	2
			£7				£7
May 1	To Balance .	b/d	2				

It will no doubt have been observed that where the right to recoup short workings exists for a specified period from the *commencement* of the agreement, the question really resolves itself into two parts: (1) The right of recoupment of short workings extending in the ordinary way, taking the last year in which the recoupment is possible as the equivalent of the last year of a lease, and after the expiry of the specified period (2) without right of recoupment existing at all. In other words, there are two distinct arrangements just as if the early years where recoupment is possible were covered by one lease and superseded by a new one containing no such right. Therefore, at the expiry of the first "break" it will be necessary to write off the short workings irrecoverable (if any).

Illustration. Royalty is 1s. per ton; the right of recoupment of short workings to extend for four years only from the commencement of the lease (i.e. three years from the end of the first year). Minimum rent, £70 per annum. Yearly output as shown in column 2 below. Show, in columnar form, the accounts in the books of the Lessee.

(1) Year	(2) Tons	Royalty		Landlord		Short Workings		Short Workings Irrecoverable	
		Dr.	*Cr.*	*Dr.*	*Cr.*	*Dr.*	*Cr.*	*Dr.*	*Cr.*
		£	£	£	£	£	£	£	£
1 .	1,000	50			70	20			
2 .	1,500	75		5	75		5		
3 .	2,000	100		15	100		15		
4 .	1,200	60			70			10	
		[expiry of the "recoupment" period]							
5 .	1,000	50			70			20	
6 .	800	40			70			30	
7 .	1,500	75			75				
8 .	2,100	105			105				

In the fourth year the whole of the balance of short workings unrecouped must be written off. In the fifth year (and subsequently) the short workings are written off *at once* because they are not recoupable.

It will therefore be clear that from the *fourth* year the landlord obtains the royalty or minimum rent, whichever is the greater.

It may here be noted that, where the minimum rent exceeds the royalties, the amount deductible from profits for taxation purposes is the minimum rent and not the lesser royalties on tonnage (*C.I.R.* v. *Cranford Ironstone Co.*, 1942). Where short workings are carried forward in the accounts with only the actual tonnage royalty transferred to Production Account, the necessary adjustment can be effected in the tax computations without altering the books. On the other hand, should it be desired to write off the whole minimum rent (even though there is a right to recoup short workings), keeping a record in the books of Short Workings recoverable, this may be done with the following entry, in addition to those already detailed: debit Profit and Loss Account with short workings to be written off; credit Short Workings Suspense. The balance on this account will offset the balance on Short Workings Account; and where any of the latter balance is used under the right of recoupment, a similar amount must be written back to Profit and Loss Account from the Suspense. Probably, however, a Memorandum Short Workings Account would suffice, thus avoiding the creation of the Suspense Account.

Summary of General Principles. Before sub-royalties are dealt with the general principles already dealt with are summarized below—

(1) There may be no right at all to recoup short workings.

(2) Where the right to recoup short workings exists, it may be subject to a limitation as to the period within which the right may be exercised, e.g.—

(*a*) A certain number of years from the commencement of the lease or agreement.

(*b*) A certain number of years from the end of the year in which the deficiency occurs.

Therefore particular attention should be given to the *dates and the terms of the Lease.*

(3) Unless some covenant to the contrary is contained in the lease, the balance of short workings, inclusive of the amount arising in the last year of the lease, is irrecoverable.

(4) The landlord, in circumstances (1), will always be entitled to the amount of royalty or minimum rent, whichever is the *greater.*

(5) Once the short workings balance is eliminated, the landlord will receive in one year (until another deficient year arises) the full royalty, subject to the deduction of income tax where necessary.

(6) Where the time limit for recouping short workings has expired, the treatment of royalties for subsequent years is exactly as if no right to recoup existed, and the irrecoverable short workings are at once written off.

(7) The Short Workings Account must never have a CREDIT balance unless there is some exceptional agreement, e.g. to anticipate short workings in future years.

(8) (*a*) If the royalty is LESS than the minimum rent, the landlord is credited with the higher figure (i.e. minimum rent) and the Short Workings Account debited with the difference.

(*b*) If the royalty EXCEEDS the minimum rent the landlord is first credited with the higher figure (i.e. royalty), and, secondly, his account is debited and Short Workings Account credited with the recoupable short workings, if any, the latter transfer being restricted where necessary, to leave the landlord in credit for his minimum rent.

Sub-Royalties. It frequently happens that a concern obtains a lease of land on which to work a mine or quarry, the terms being the usual royalty, merging in a minimum rent with a right of recoupment of short workings, coupled with the right to sublet part of the land to a sub-lessee.

The entries in the lessee's books in respect of royalty receivable are reverse to those relating to royalty payable. Should the sub-letting be at a higher rate than that payable by the lessee to the landlord, such excess is a profit to be credited to Profit and Loss Account; otherwise the amount receivable from the sub-lessee is credited to the Production Account against the royalty payable by the lessee, since the latter accounts to his landlord for the royalty upon the WHOLE output. Usually separate accounts for the royalty receivable and payable are opened, although one account only may be employed; but in both instances the net royalty payable will be transferred to the debit of Production Account.

Illustration. P. Quick obtains a lease from R. Rich to work a mine, the terms being a royalty of 1s. per ton merging into a minimum rent of £100 per annum, there being granted to the lessee the right to recoup short workings over the whole period of the lease. P. Quick sublets part of the property to V. Poor, the terms being a royalty of 1s. per ton merging in a minimum rent of £48 per annum, recoupment being available over the whole period of the sub-lease. The amount of ore extracted is as follows—

Year	P. Quick	V. Poor	Total Production
	(Tons)	(Tons)	(Tons)
1 . .	1,100	400	1,500
2 . .	1,160	540	1,700
3 . .	1,300	700	2,000
4 . .	1,400	900	2,300
5 . .	1,800	1,200	3,000
6 . .	800	1,200	2,000

The entries in the books of the lessee, in abbreviated tabular form, will be—

Year	Royalty Payable	Landlord		Short Workings		Sub-lessee		Royalty Receivable	Royalty Suspense		[Yearly Balance of Royalty Suspense]
	Dr.	*Dr.*	*Cr.*	*Dr.*	*Cr.*	*Dr.*	*Cr.*	*Cr.*	*Dr.*	*Cr.*	*Cr.*
	£	£	£	£	£	£	£	£	£	£	£
1 .	75		100	25		48		20		28	28
2 .	85		100	15		48		27		21	49
3 .	100		100			48		35		13	62
4	115	15	115		15	48		45		3	65
5 .	150	25	150		25	60	12	60	12		53
6 .	100		100			60	12	60	12		41
	[Total £625]	[Total net credit, £625]				[Total net debit, £288]		[Total £247]			[Carry fwd. as liability £41]

It will be observed that the lessee, having no more short workings, has paid over the period the precise sum due based on output.

As regards the sub-lessee (who will make entries in his books on the principles outlined), he may be regarded as in a similar position in respect to the lessee as the latter is to the landlord, so that the entries in the books of the lessee, so far as the royalty he obtains from the sub-lessee is concerned, are, as mentioned, the reverse to those already explained. So long as it is perceived that for the purposes of book-keeping, Quick is Poor's landlord, the entries are identical with those of a landlord in the strict legal sense, and are reverse to those made in Poor's books.

The suspense is obviously the equivalent, viewed from the opposite angle, of short workings, and just as the lessee carries forward as an asset his short workings, so a landlord carries forward the suspense to cover diminutions of royalty receivable arising from recoupments of short workings.

The student will readily observe that in the books of Poor the figures will (with the altered headings of accounts) be found on the opposite sides to the above, e.g. year 1—

	Royalty Payable	"Landlord" (i.e. Quick)	Short Workings
	Dr.	*Cr.*	*Dr.*
	£	£	£
Year 1 . .	20	48	28

It should be noted that Quick so far will have received £288 against royalty of £247, leaving £41 in suspense; but if the sixth year were the final year, Quick would lose nothing (he has no short

workings) but Poor would lose the £41 short workings now irrecoverable. Quick would therefore debit the suspense and credit his Profit and Loss Account with £41.

The Ledger Accounts are shown for the first and second years—

Dr. ROYALTY RECEIVABLE *Cr.*

			£				£
Year 1	To Royalty Payable		20	Year 1	By V. Poor		20
" 2	" " "		27	" 2	" "		27

Dr. ROYALTY SUSPENSE *Cr.*

			£				£
Year 1	To Balance	c/d	28	Year 1	By V. Poor		28
" 2	" "	c/d	49	" 2	" Balance	b/d	28
					" V. Poor		21
			49				49
				" 3	" Balance	b/d	49

Dr. V. POOR *Cr.*

			£				£
Year 1	To Sundries		48	Year 1	By Cash (and Tax)		48
" 2	" "		48	" 2	" " "		48

Dr. ROYALTY PAYABLE *Cr.*

			£				£
Year 1	To R. Rich		75	Year 1	By Royalty Receivable		20
					" Production Account		55
			£75				£75
" 2	" R. Rich		85	" 2	" Royalty Receivable		27
					" Production Account		58
			£85				£85

Dr. SHORT WORKINGS *Cr.*

			£				£
Year 1	To R. Rich		25	Year 1	By Balance	c/d	25
" 2	" Balance	b/d	25	" 2	" "	c/d	40
	" R. Rich		15				
			£40				£40
" 3	" Balance	b/d	40				

Dr. R. RICH *Cr.*

			£				£
Year 1	To Cash (and Tax)		100	Year 1	By Sundries		100
" 2	" " "		100	" 2	" "		100

Accounts in Quick's Books (see page 317)

Year	Royalty Payable		Landlord (Rich)		Short Workings		Short Workings Irrecoverable		Royalty Receivable		Sub-Lessee (Poor)		Royalty Suspense		Profit and Loss		Yearly Balance of Royalty Suspense	
	Dr. £	Cr. £	Dr. £	Cr. £	Dr. £	Cr. £	Dr. £	Cr. £	Dr. £	Cr. £	Dr. £	Cr. £	Dr. £	Cr. £	Dr. £	Cr. £	Dr. £	Cr. £
1 . .	75			100	25					20	48			28				28
2 . .	85			100	15					27	48			21				49
3 . .	100			100						35	48		(a) 28	13		(a) 28		34
4 . .	115		15	115		15												
						25	25			45	48		(b) 21	3		(b) 21		16
5 . .	150			150						60	60	(c) 12	(c) 12					
													(d) 4			(d) 4		nil
	£525		[Net £5	credit 50]	£40	£40	£25			£187	[Net £2	debit 40]	£65	£65		£53		

Notes—

(*a*) In year 3 there is a commencing balance of £49, of which £28 must be recouped, if at all, in that year; but it is not possible, as another deficiency has arisen, so that £28 becomes profit to Quick (and loss to Poor). This reduces the Suspense to £21, but a further addition of £13 arises, thus making the carry forward £34.

(*b*) In year 4 the short workings recoupable from year 2 are not utilizable by Poor, as another shortage has occurred, hence this is treated as profit to Quick, thus reducing the balance of Suspense from £34 to £13, to which, however, must be added £3 (the current year shortage), making a carry forward of £16. (It must be remembered that the £3 can only be recovered by Poor in year 5, as this is the FINAL year of the lease.)

(*c*) In year 5 the maximum amount of short workings recoverable by Poor is £12, as Quick must at least receive £48. The balance of £16 less £12 recoupable leaves a net balance of £4 to be taken to the Profit and Loss Account of Quick.

(*d*) The £4 is made up of the balance of year 3 [£13 less £12 recouped] £1, plus year 4, £3.

The position, when there is a limitation to the time of recoupment, is now shown.

Illustration. Using the same data as in the foregoing illustration save that there is a clause whereby Quick is to have a right of recoupment over the first four years of the lease, whilst Poor has the right of recoupment as against Quick for the two years following the short workings, and that the lease and sub-lease are for five years only (so that the sixth year figures are eliminated), show Accounts in Quick's books (see page 316).

It will be seen that the total royalties are £525 [10,500 tons at 1s.] but the landlord has received £550, reflected in the former figure and short workings irrecoverable.

The Royalty receivable is £187 [3,740 tons at 1s.] but the lessee has received £240, reflected in the former figure and the short workings irrecoverable by the sub-lessee.

If the lessee sublets at a profit, e.g. he pays a royalty of 1s. per ton on the whole output, but charges 1s. 6d. per ton on the output of the sub-lessee, he has, subject to short workings adjustments, a profit of 6d. per ton on the sub-lessee's output, which will be credited to Profit and Loss Account.

Illustration. Assume that short workings are recoverable during the period of a lease of three years, and the output is as follows—

Year	Output in Tons [Total]	Lessee's Output in Tons	Sub-lessee's Output in Tons
1	1,400	400	1,000
2	2,300	1,700	600
3	3 000	2,280	720
	[at 1s per ton]		[at 1s 6d per ton]

Minimum Rent—Landlord to Lessee, £100.
,, Lessee to Sub-lessee, £60.

Show entries in Lessee's books.

The entries, in summary form in the books of the Lessee, will be—

Year	Royalty Payable	Landlord		Short Workings		Royalty Receivable	Sub lessee	Royalty Suspense
	Dr.	Dr	Cr	Dr	Cr.	Cr	Dr	Cr.
	£	£	£	£	£	£	£	£
1	70		100	30		75	75	
2	115	15	115		15	45	60	15
3	150	15	150		15	54	60	6
	(a) £335	[Total credit	net £335]	£30	£30	(b) £174	£195	(c) £21

(a) 6,700 tons at 1s.
(b) 2,320 tons at 1s 6d
(c) Transferred to credit of Profit and Loss Account.

CHAPTER XVI

JOINT VENTURE ACCOUNTS

THE most usual joint ventures met with in practice are those relating to the dealings in a consignment of merchandise, (e.g. the purchase and sale of a bankrupt firm's stock) or to dealings in stocks and shares.

If the venture is of sufficient magnitude to warrant a distinct set of books being kept, no special book-keeping treatment is necessary; but where the books of each party record *only* such transactions as directly concern him, special treatment is necessary.

In cases of this type, each party opens one account only; that is, the account relating to the venture. This account is treated as a personal account, being debited with all payments made by, and credited with all receipts of, the person in whose books it is opened. The account is headed "JOINT VENTURE with ——" and forms part of the double entry of the party making the entries.

Illustration. A and B enter into a joint venture. The necessary accounts are, therefore—

In A's books—	*In B's books—*
JOINT VENTURE with B	JOINT VENTURE with A

In addition to the personal accounts, a Memorandum Joint Venture Account will be written up in order to ascertain the total profit or loss on the adventure. When the profit or loss has been ascertained, it will be divided between the parties in their agreed ratio, or if none is agreed, equally. If a profit has been made each party will debit the Personal Account of his co-venturer in his books with his *own* share and credit "Profit and Loss on Joint Venture Account." There will be converse entries for a loss. This is the entry that causes most difficulty in Joint Venture Accounts, and particular note should be made of the correct treatment. The ordinary rule for nominal accounts applies, namely, DEBIT LOSSES, CREDIT GAINS.

Rules for Joint Venture Accounts. The rules for Joint Venture Accounts may be summarized as follows—

(1) Each party will open a Personal Account, Joint Venture with . . . Account, and will make the following entries therein—

DEBIT Joint Venture with . . . Account with the contributions and expenses incurred by him on behalf of the Joint Venture.

CREDIT Cash or Creditors.

DEBIT Cash or Debtors.

CREDIT Joint Venture with . . . Account with all Sales made by him appertaining to the Joint Venture.

(2) The Memorandum Joint Venture Account will be drawn up in the same manner as a Profit and Loss Account, i.e. DEBIT losses, CREDIT gains. This Memorandum Account represents a complete account of all the transactions affecting the venture, i.e. the details contained in the Personal Accounts of both parties are entered in full in the Memorandum Account on the same side as in the Personal Accounts (*contra* items, such as cash and bills of exchange passing between the parties, being eliminated). The balance of this account will represent the profit or loss on the venture.

(3) Each party will, in his own books—

(*a*) Debit the Personal Account of the other party with his *own* share of profit (credit Profit and Loss on Joint Venture Account).

(*b*) Credit the Personal Account of the other party with his *own* share of loss (debit Profit and Loss on Joint Venture Account).

(4) The Personal Accounts of each party will now be found to show the same balance; such balances, however, will appear on the opposite sides in the respective books. For example, if A's books show a credit balance of £100 in favour of B, B's books will show a debit balance against A for the same amount.

Illustration. A and B enter into a joint venture in timber. A pays for timber £100, and expenses £10. B sells all the timber for £200 and pays expenses £40. They share profits and losses, three-fifths to A and two-fifths to B. Show Accounts (see page 320).

The balances on the accounts, which agree, will be settled by B giving A a cheque for £140.

It should be noted, therefore, that the Memorandum Joint Account is merely a combination of the two Personal Accounts. The vital object of this account is to find the Profit or Loss, from which each party will enter in his own books his share of profit by DEBITING his co-venturer (and crediting Profit and Loss on Joint Venture Account); and conversely for losses. As the two separate Personal Accounts contain, on the SAME sides, the contents of the Memorandum Joint Venture Account they must as between themselves be reflective, provided the balancing figure of the Memorandum Joint Venture Account is shown on the *same* side in the Personal Accounts and in the Memorandum Joint Venture Account.

Stock. Where the goods relating to the adventure are provided by one of the parties out of his ordinary business goods, that party will DEBIT the Personal Account of the other and CREDIT Purchases[1] Account with the figure at which it is agreed the goods shall be valued. This figure will, of course, be entered in the Memorandum Joint Venture Account on the debit (i.e. "SAME" side).

[1] If the goods are valued above or below cost, Purchases Account should be credited with the cost of the goods and the balance credited or debited to Profit and Loss on Joint Venture Account.

A's Books—

Dr.	JOINT VENTURE WITH B						Cr.
Date			£	Date			£
	To Cash (or Creditors)				By Balance .	c/d	140
	Cost of Timber		100				
	Expenses .		10				
	,, Share of Profit ($\frac{3}{5}$) . .		30				
			£140				£140
	To Balance .	b/d	140				

B's Books—

Dr.	JOINT VENTURE WITH A						Cr.
Date			£	Date			£
	To Cash (or Creditors)				By Cash (or Debtors) ·		
	Expenses .		40		Sale of Timber . .		200
	,, Share of Profit ($\frac{2}{5}$) . .		20				
	,, Balance .	c/d	140				
			£200				£200
					By Balance .	b/d	140

Dr.	*Memorandum* JOINT VENTURE						Cr.
Date			£	Date			£
	To Cost of Timber		100		By Proceeds of Sale of Timber		200
	,, Expenses—						
	A . .		10				
	B . .		40				
	,, Profit—						
	A, $\frac{3}{5}$. £30						
	B, $\frac{2}{5}$. 20		50				
			£200				£200

If, at the close of the venture, there are goods on hand, and one of the parties takes them over at an agreed figure, he will **credit** the Personal Account of the other party (and debit Purchases Account with that amount). The same amount will be entered on the CREDIT side of the Memorandum Joint Venture Account (i.e. "SAME" side).

Where an intermediate settlement is desired prior to the completion of the venture, and there is a certain amount of stock in the hands of either or both parties, special treatment is necessary.

The total value of the stocks is brought down on the debit side of the Memorandum Joint Venture Account as a balance, and each party will bring down in the Personal Account in his books the amount of stock that he has on hand; this representing his share of assets still employed in the venture.

Illustration. A and B enter into a joint venture to sell a consignment of timber on 1st January, 19.., sharing profits and losses equally. A provides the timber from stock at a mutually agreed value of £500. He pays expenses amounting to £25 during January. During the month B incurs expenses £65, and receives cash for sales £300. He also takes over goods to the value of £100 for use in his own business. At 31st January the stock in A's hands is valued at £110. The remaining stock of £110 was taken over by A for £120 on 2nd February, 19...

The accounts for January and February will be as follows—

A's Books—

Dr. JOINT VENTURE WITH B **Cr.**

19..			£	19..			£
Jan. 1	To Purchases Account		500	Jan. 31	By Share of Loss		40
					" Stock	c/d	110
31	" Cash: Expenses		25		" Balance	c/d	375
			£525				£525
Feb. 1	To Stock	b/d	110	*Feb 2*	*By Purchases Account*		*120*
	" Balance	b/d	375		" *Balance*	*c/d*	*370*
2	" *Share of Profit*		*5*				
			£490				*£490*
Feb. 3	*To Balance*	*b/d*	*370*				

B's Books—

Dr. JOINT VENTURE WITH A **Cr.**

19..			£	19..			£
Jan 31	To Cash: Expenses		65	Jan 31	By Cash: Sales		300
	" Balance	c/d	375		" Purchases Account		100
					" Share of Loss		40
			£440				£440
Feb 2	*To Share of Profit*		*5*	Feb. 1	By Balance	b/d	375
	" *Balance*	*c/d*	*370*				
			£375				*£375*
				Feb. 3	*By Balance*	*b/d*	*370*

Dr.				*Memorandum* Joint Venture			Cr.
19..			£	19..			£
Jan. 1	To Cost of Timber .		500	Jan. 31	By Sales . .		300
	,, Expenses:				,, B: Stock taken over		100
31	A. . £25				,, Stock . .	c/d	110
	B. . 65		90		,, Loss—		
					A, ½. £40		
					B, ½. 40		80
			£590				£590
Feb. 1	To Stock . .	b/d	110	*Feb 2*	*By A. Stock taken over* .		*120*
2	,, *Profit—*						
	A, ½ £5						
	B, ½ . 5		*10*				
			£120				*£120*

Note. *February entries are in italics.*

An alternative method of bringing down the stock is to divide it up between the two parties in their profit-sharing ratios, and for each party to bring into the account in his books his share of the stock. In the account, this balance should be brought down separately and not merged in with the other items.

In the above illustration the balances brought down in the respective accounts would be as follows—

A's Books—

Dr.				Joint Venture with B			Cr.
19..			£	19..			£
Jan. 1	To Purchases Account .		500	Jan. 31	By Share of Loss		40
31	,, Cash: Expenses .		25		,, Stock . .	c/d	55
					,, Balance .	c/d	430
			£525				£525
Feb. 1	To Stock . .	b/d	55	*Feb. 2*	*By Purchases Account* .		*120*
	,, Balance .	b/d	430		,, *Balance* .	*c/d*	*370*
2	,, *Share of Profit*		*5*				
			£490				*£490*
Feb. 3	*To Balance* .	*b/d*	*370*				

B's Books—

Dr. JOINT VENTURE WITH A *Cr.*

			£				£
19.. Jan. 31	To Cash: Expenses .		65	19.. Jan. 31	By Cash: Sales .		300
	" Balance .	c/d	430		" Purchases Account .		100
					" Share of Loss		40
					" Stock . .	c/d	55
			£495				£495
Feb. 1	To Stock . .	b/d	55	Feb. 1	By Balance .	b/d	430
2	" *Share of Profit*		*5*				
	" *Balance* .	*c/d*	*370*				
			£430				*£430*
				Feb 3	*By Balance* .	*b/d*	*370*

This method has the advantage of showing—

(1) the reflective nature of the balances in each person's books;

(2) the respective interests in the stock.

If, in the above method, the whole of the stock is lost and written off, each party will write off £55, thus leaving a reciprocal balance of £430 to be settled by a cash payment in the ordinary way.

Stock in hand at the balancing date may usually be valued on the basis of cost plus a due proportion of the expenses attributable thereto (e.g. purchasing expenses, carriage inwards, etc., but not selling or distribution costs) or at market value, if lower. Where other assets are held and depreciation is to be taken into account, the assets may be brought into the account at the balancing date at their written down value, the depreciation charge being thus automatically included in the Profit or Loss figure. This can, of course, only be done where the assets have been previously debited to the Joint Venture Accounts. Otherwise, the agreed depreciation charges will be debited to the respective Joint Venture Accounts and credited to the respective Depreciation Accounts (or Asset Accounts).

Interest. Where the parties agree to the charging of interest on the various debits and credits to the date of completion of balancing, the Joint Venture Accounts are treated as Accounts Current.

In the *Memorandum* Joint Venture Account care must be taken to insert the interest figure **before** ascertaining the profit or loss on the venture. In the books of the respective parties the double entry for the amount of interest charged or allowed in the Joint Venture Accounts occurs in the INTEREST ACCOUNT, the balance of which is transferred to Profit and Loss Account. The interest on the cash transactions between the parties will not appear in the Memorandum Joint Venture Account as this is a charge affecting the parties themselves and distinct from the venture expenses.

A's Books (see page 326)—

Dr. **Joint Venture with B** *Cr.*

Date		Fol.	Months	Interest			Principal			Date		Fol.	Months	Interest			Principal		
19..				£	s.	d.	£	s.	d.	19..				£	s.	d.	£	s.	d.
Jan. 1	To Cash: Goods		6	10	0	0	400	0	0	Jan. 1	By *Cheque*		6	3	15	0	150	0	0
Feb. 1	,, ,, Expenses		5		12	6	30	0	0	June 1	,, *Bill due 4th Sept.*						250	0	0
Apr. 1	,, ,, ,,		3		7	6	30	0	0	30	,, Interest						3	15	0
June 30	,, Interest on Bill *Contra*		2	2	1	8					,, *Cheque from B*						106	4	2
	,, Share of Profit						36	17	6										
	,, Interest						13	1	8										
				£13	1	8	£509	19	2					£3	15	0	£509	19	2

B's Books—

Dr. **Joint Venture with A** *Cr.*

Date		Fol.	Months	Interest			Principal			Date		Fol.	Months	Interest			Principal		
19..				£	s.	d.	£	s.	d.	19..				£	s.	d.	£	s.	d.
Jan. 1	To *Cheque*		6	3	15	0	150	0	0	Apr. 1	By Cash: Sales		3	6	0	0	480	0	0
Mar. 1	,, Cash: Expenses		4		13	4	40	0	0	June 30	,, ,, ,,		—				240	0	0
May 31	,, ,, ,,		1		11	8	140	0	0		,, Interest on Bill *Contra*		2	2	1	8			
June 1	,, *Bill due 4th Sept.*						250	0	0		,, Interest						8	1	8
30	,, Share of Profit						36	17	6										
	,, Interest						5	0	0										
	,, *Cheque to A*						106	4	2										
				£5	0	0	£728	1	8					£8	1	8	£728	1	8

Dr. *Memorandum* JOINT VENTURE *Cr.*

Date		Months	Interest £	s.	d.	Principal £	s.	d.	Date		Months	Interest £	s.	d.	Principal £	s.	d.
19..									19..								
Jan. 1	To Goods .	6	10	0	0	400	0	0	Apr. 1	By Sales .	3	6	0	0	480	0	0
Feb. 1	„ Expenses—A	5		12	6	30	0	0	June 30	„ „	—				240	0	0
Mar. 1	„ „ B	4		13	4	40	0	0		„ Interest					6	0	0
Apr. 1	„ „ A	3		7	6	30	0	0									
May 31	„ „ B	1		11	8	140	0	0									
June 30	„ Interest					12	5	0									
	„ Profit— £ s. d.																
	A, ½ . 36 17 6																
	B, ½ . 36 17 6					73	15	0									
			£12	5	0	£726	0	0				£6	0	0	£726	0	0

Note. No interest on Cash passing between the partners is included in the Memorandum Joint Venture Account.

Except for the items in italics, the entries in the Personal Accounts are virtually duplicates on the SAME side as those in the Memorandum Joint Venture Account. The *net* interest in debit in the latter account is £6 5s., i.e. £12 5s. *less* £6.

In the Personal Accounts the interest items are shown—

		£	s.	d.	
(1) B's Account in A's books . .	*Dr.*	9	6	8	[i.e. *Dr.* £13 1s. 8d.; *Cr.* £3 15s. 0d.]
(2) A's Account in B's books . .	*Cr.*	3	1	8	[i.e. *Cr.* £8 1s. 8d.; *Dr.* £5 0s. 0d.]
Net Interest, as above . .	*Dr.*	£6	5	0	

In examinations, the details of interest need not be repeated in the memorandum Joint Venture Account, but merely the *net balance* of interest as per the personal accounts of the venturers (i.e. £6 5s. debit).

Illustration. A and B enter into a joint venture in timber. On 1st January, 19.., A buys timber, costing £400, and on the same day he receives a cheque from B for £150. A and B pay expenses as follows—

	A		B
1st Feb. . . .	£30	1st Mar. . . .	£ 40
1st Apr. . . .	£30	31st May. . .	£140

B sells the timber in two amounts, namely, 1st April £480 and 30th June £240. They share profits and losses equally, and interest is to be allowed at 5 per cent per annum. On 1st June B gives A a three months' bill for £250, and on 30th June the venture is completed by a cheque between the parties. Calculate interest in months. Show accounts (see pages 324 and 325.)

Complete Double Entry Books. It has already been mentioned that, where the circumstances warrant the inauguration of a complete set of double entry books for the venture, no peculiarity of treatment usually arises in respect of the transactions. At the same time, it must be pointed out that in the separate books of each venturer cognizance must be taken of the amounts invested in, and the final result of, the venture. These entries in the latter books will be very similar to those arising where no separate double entry system of accounts exists for the venture. In other words, whatever the mode of procedure adopted for the ascertainment of the profit or loss on the venture may be, the entries made by each venturer in his own books will remain unaffected; hence, the entries in the double entry books of each venturer will be unaffected by the completeness or incompleteness of the records of the joint venture transactions themselves. The entries in the venturers' own books are—

(1) The Assets brought into the joint venture are debited to the Personal Account of the co-venturer. (Cash, Bank, Purchases or Asset Account credited.)

(2) Any receipt of bills of exchange or cash from the joint venture is credited to the Personal Account of the co-venturer. (Cash or Bills Receivable Account debited.)

(3) Any taking over of goods or other assets: the Personal Account of the co-venturer is credited. (Purchases or Asset Account debited.)

(4) Profit on the venture is **debited** to the Personal Account of the co-venturer and credited to Profit and Loss Account; any loss being **credited** to the Personal Account and debited to Profit and Loss Account.

In the Double Entry Joint Venture books there will appear a Personal Account for each venturer, who will be in credit for his contributions plus profits and less losses and drawings (if any). The balance of such Personal Account, if in credit, must correspond to the **debit** balance standing on the Joint Venture or Co-venturer's Account in the books of the venturer to whom the Personal Account relates.

The important point that requires emphasis is that if the parties

are, say, A and B, the debit balance in A's books of account against B will be identical with the credit balance in the joint venture books in favour of A in respect of the latter's contributions, expenses, and share of profit, less any amounts received in respect of sales, withdrawals of cash or goods, and share of losses, because from each point of view it represents an amount owing to A by B. In the joint venture books A is a creditor; in A's own books, therefore, B is a debtor. Similarly, in B's books, A will be in debit for B's contributions, expenses, and share of profit, less any amounts received in respect of sales, withdrawals of cash or goods, and share of losses, and this amount will be reflective of the amount of the credit balance standing in favour of B in the books of account of the joint venture. Thus in B's books A is a debtor and in the joint venture books B is a creditor. If the co-venturers have overdrawn the amount of their original capital contributions the position will be reversed, the debit balances appearing in the joint venture books being the credit balances on the accounts of the respective venturers in each other's books.

The principle is illustrated below. The facts are made simple in order that the student may concentrate his attention solely on the principle involved above.

Illustration. A and B enter into a joint venture, contributing £1,000 and £800 respectively and sharing profits and losses 3 : 4. The purchases are £1,600 and the sales £2,000. The remaining stock is taken over by B for £100. Expenses paid are £60, and expenses outstanding unpaid, £20. Complete double entry records are kept. All transactions are for cash. A drew out £400.

Show the accounts—

(1) In the separate joint venture books.

(2) In each of the co-venturers' books as regards the Personal Accounts only.

JOINT VENTURE BOOKS

Dr. JOINT VENTURE TRADING ACCOUNT *Cr.*

		£			£
To Purchases		1,600	By Sales		2,000
,, Cash: Expenses		60	,, B: Goods taken over		100
,, Expenses	c/d	20			
,, Profits— A, $\frac{3}{7}$ £180; B, $\frac{4}{7}$ 240		420			
		£2,100			£2,100
			By Expenses	b/d	20

Dr. A Cr.

			£				£
	To Cash .		400		By Cash .		1,000
	" Balance .	c/d	780		" Share of Profits .		180
			£1,180				£1,180
					By Balance .	b/d	780

Dr. B Cr.

			£				£
	To Joint Venture Trading Account Goods taken over .		100		By Cash .		800
	" Balance .	c/d	940		" Share of Profits .		240
			£1,040				£1,040
					By Balance .	b/d	940

Dr. CASH Cr.

			£				£
	To A . .		1,000		By Joint Venture Trading Account Purchases .		1,600
	" B . .		800		" Joint Venture Trading Account Expenses .		60
	" Sales .		2,000		" A . .		400
					" Balance .	c/d	1,740
			£3,800				£3,800
	To Balance .	b/d	1,740				

It will be observed that the cash balance in hand is now sufficient to pay off the expense creditor (or creditors) for £20, and to pay out the venturers' balances.

The personal accounts of B and A in the books of A and B respectively are—

A's Books—

Dr.	JOINT VENTURE WITH B					*Cr.*
			£			£
To Cash .		1,000	By Cash .		400
" Share of Profits .		180	" Balance .	c/d	780
		£1,180			£1,180
To Balance .	b/d	780			

B's Books—

Dr.	JOINT VENTURE WITH A				*Cr.*
		£			£
To Cash .		800	By Goods taken over		100
" Share of Profits .		240	" Balance .	c/d	940
		£1,040			£1,040
To Balance .	b/d	940			

On settlement of the final balance the usual entries will be made, viz.—

In the Joint Venture books: debit A, £780; debit B, £940; debit Joint Venture Trading Account, £20: credit cash, £1,740.

In A's books: debit cash, £780; credit Joint Venture with B Account, £780.

In B's books: debit cash, £940; credit Joint Venture with A Account, £940.

The following illustration should be carefully worked through, as it is considerably involved in detail.

General Illustration. Andrews and Bailey enter into a joint venture for the holding, purchase, and sale of investments, profits and losses to be shared in the ratio 3 : 2.

On 30th September, 1952, are purchased the following shares—

200 in A, Ltd., for £384
200 in B, Ltd., for £757
40 in R, Ltd., for £733

These are paid for on 1st October: Andrews provides £1,174 and Bailey pays the balance direct to the broker. The following are the dividends received and the transactions entered into—

Dividends Received—

1952		£
Nov. 30.	Interim Dividend, A, Ltd.	36
Dec. 30.	Dividend, X, Ltd.	7

1953			£
Jan. 1.	Dividend B, Ltd	. . . .	58
	Bonus of one Share for every two held, A, Ltd.		

Dealings—

1952			
Nov. 8.	Sale of 30 Shares in R, Ltd.	. . . . .	405
Dec. 6.	100 Shares in B, Ltd., taken over by Andrews	.	280
1953			
Jan. 15.	Sale of 10 Shares in R, Ltd..	. . . . .	120
Feb. 21.	Sale of 250 Shares in A, Ltd.	. . . . .	455

On 8th November, 1952, £81 is remitted to Bailey by the broker out of the proceeds of sale of 30 shares in R, Ltd.

On 1st December, 1952, were purchased 100 shares in X, Ltd., the broker, Roberts, agreeing to lend the £200 necessary for their purchase with interest at 5 per cent per annum, the sum to be repaid not later than 31st January, 1953. The shares are registered in the name of Roberts, and the dividend of £7 received on 30th December is applied in part repayment of the loan. The money received from the sale of ten shares in R, Ltd., on 15th January, 1953, is similarly applied in part repayment of the loan. On 31st January, 1953, the balance of the loan is completely repaid by cash.

The values of the holdings at 28th February, 1953, are—

100 Shares in B, Ltd., £450
100 Shares in X, Ltd., £80

The value of the holding in A, Ltd., is to be based on the fact that the purchase price at 30th September, 1952, included provision for four months' dividend, the half year's dividend of £36 being paid on 30th November, 1952. The true cost value at 28th February, 1953 (taking bonus shares into account), is to be the basis of valuation of this investment. Subject to this proviso, all other dividends are to be considered as income.

The accounts recording these transactions in the Joint Venture books are required.

Dr. JOINT VENTURE BANK *Cr.*

			£	s.	d.				£	s.	d.
1952						1952					
Sept. 30	To Andrews .		1,174	0	0	Oct. 1	By Broker .		1,174	0	0
Nov. 8	,, Broker .		324	0	0	1953					
30	,, Dividend: A, Ltd. .		36	0	0	Jan. 31	,, ,, .		74	7	9
						Feb. 28	,, Balance .	c/d	798	12	3
1953											
Jan. 1	,, Dividend: B, Ltd. .		58	0	0						
Feb. 21	,, Broker .		455	0	0						
			£2,047	0	0				£2,047	0	0
Mar. 1	To Balance .	b/d	798	12	3						

Joint Venture Books—

Dr. JOINT VENTURE *Cr.*

			Nominal	Principal						Nominal	Principal		
1952			£	£	s.	d.	1952			£	£	s.	d.
Sept. 30	To Broker—						Nov. 8	By Broker—					
	Purchase of Shares:							Sale of Shares:					
	A, Ltd. . .		200	384	0	0		R. Ltd. . .		30	405	0	0
	B, Ltd. . .		200	757	0	0	30	,, Cash—					
	R, Ltd. . .		40	733	0	0		Dividend, A, Ltd. .			36	0	0
Dec. 1	,, Broker—Purchase of						Dec. 6	,, Andrews: Investment					
	Shares: X, Ltd. .		100	200	0	0		taken over—Shares					
1953								B, Ltd. . . .		100	280	0	0
Jan. 1	,, Bonus Dividend—						30	,, Broker—					
	A, Ltd. . .		100					Dividend: X, Ltd. .			7	0	0
31	,, Broker's Interest .			1	7	9	1953 Jan. 1	,, Cash—					
								Dividend, B, Ltd. .			58	0	0
							15	,, Broker—Sale of Shares:					
								R, Ltd. . . .		10	120	0	0
							Feb. 21	,, Broker—Sale of Shares:					
								A, Ltd. . . .		250	455	0	0
							28	,, Balance—					
								Shares, A, Ltd. .	c/d	50	60	0	0
								,, B, Ltd. .	c/d	100	450	0	0
								,, X, Ltd. .	c/d	100	80	0	0
								,, Loss—					
								Andrews £74 12 7					
								Bailey 49 15 2			124	7	9
			£640	£2,075	7	9				£640	£2,075	7	9
Mar. 1	To Balance . . .	b/d	250	590	0	0							

BAILEY

Dr.			£	s.	d.		Cr.		£	s.	d.
1952 Nov. 8	To Broker		81	0	0	1952 Oct. 1	By Broker		700	0	0
1953 Feb. 28	,, Loss from Joint Venture Account		49	15	2						
	,, Balance	c/d	569	4	10						
			£700	0	0				£700	0	0
						1953 Mar. 1	By Balance	b/d	569	4	10

ANDREWS

Dr.			£	s.	d.		Cr.		£	s.	d.
1952 Dec. 6	To Joint Venture Account — 100 Shares in B, Ltd.		280	0	0	1952 Oct. 1	By Cash		1,174	0	0
1953 Feb. 28	,, Loss from Joint Venture Account		74	12	7						
	,, Balance	c/d	819	7	5						
			£1,174	0	0				£1,174	0	0
						1953 Mar. 1	By Balance	b/d	819	7	5

In order to show the credit balances of Bailey and Andrews more analytically, they might be subdivided into two parts, attributable to realized and unrealized profit respectively, i e.—

	Bailey £	s.	d.	Andrews £	s.	d.
Realized	215	4	10	583	7	5
Unrealized	354	0	0	236	0	0
	£569	4	10	£819	7	5

The realized profits represent the "safe" and the unrealized the speculative balances: the latter would, or should, be held back pending the disposal of the remaining shares valued in the books at £590, which, if wholly lost, would be debited to Bailey and Andrews in the r[illegible] of 3 : 2, i.e. £354 and £236

Dr. LOAN (BROKER) Cr.

		Months	Interest £	s.	d.	Principal £	s.	d.			Months	Interest £	s.	d.	Principal £	s.	d.
1952 Dec. 30	To Dividend—X, Ltd.	1			7	7	0	0	1952 Dec. 1	By Joint Venture Account—Purchase of 100 Shares in X, Ltd. . .	2	1	13	4	200	0	0
1953 Jan. 15	,, Sale of Shares in R, Ltd. . .	½		5	0	120	0	0									
31	,, Cheque . .					74	7	9	1953 Jan. 31	,, Interest from *contra* .					1	7	9
	,, Interest to *contra* .		1	7	9												
			£1	13	4	£201	7	9				£1	13	4	£201	7	9

Dr. BROKER Cr.

		£	s.	d.			£	s.	d.
1952 Oct. 1	To Bailey—Cash . . .	700	0	0	1952 Sept. 30	By Joint Venture Account—			
	,, Cheque	1,174	0	0		200 Shares: A, Ltd. .	384	0	0
						200 Shares: B, Ltd. .	757	0	0
						40 Shares: R, Ltd. .	733	0	0
		£1,874	0	0			£1,874	0	0
Nov. 8	To Joint Venture Account—Sale of 30 Shares in R, Ltd. .	405	0	0	Nov. 8	By Bailey	81	0	0
						,, Cash	324	0	0
1953 Feb. 21	,, Joint Venture Account—Sale of 250 Shares in A, Ltd. .	455	0	0	1953 Feb. 21	,, Cash	455	0	0

Trial Balance
28th Feb., 1953

	Dr. £	s.	d.	Cr. £	s.	d.
Bank	798	12	3			
Shares per Joint Venture Account	590	0	0			
Andrews				819	7	5
Bailey				569	4	10
	£1,388	12	3	£1,388	12	3

As regards the valuation of the holding in A, Ltd., after the issue of the bonus, 300 shares are held for a cost of £360; 50 shares, i.e. one-sixth, remain at 28th February, 1953, and are valued at

$$\tfrac{1}{6} \times £360 = £60$$

It should be noted that the opening payment by Bailey is transferred direct from Bailey's account to that of Roberts, the broker. In theory, such a transfer requires a Journal entry to record it.

The actual results, profit or loss, of the dealings in each investment can be shown (apart from dividends received, which may be recorded in a separate Dividend Account) by opening a separate account for each investment.

Dr. **Shares in A, Ltd.** *Cr.*

Date			Nom £	£	Date			Nom £	£
1952 Sept. 30	To Broker		200	384	1952 Nov. 30	By Dividend			24
1953 Jan. 1	,, Bonus		100		1953 Feb. 21	,, Broker: Sale		250	455
Feb. 28	,, Profit			155	28	,, Balance	c/d	50	60
			£300	£539				£300	£539
Mar. 1	To Balance	b/d	50	60					

Dr. **Shares in B, Ltd.** *Cr.*

Date			Nom £	£	Date			Nom £	£
1952 Sept. 30	To Broker		200	757	1952 Dec. 6	By Andrews		100	280
					1953 Feb. 28	,, Balance	c/d	100	450
						,, Loss			27
			£200	£757				£200	£757
1953 Mar. 1	To Balance	b/d	100	450					

Dr. **Shares in R, Ltd.** *Cr.*

Date			Nom £	£	Date			Nom £	£
1952 Sept. 30	To Broker		40	733	1952 Nov. 8	By Broker: Sale		30	405
					1953 Jan. 15	,, Broker: Sale		10	120
					Feb. 28	,, Loss			208
			£40	£733				£40	£733

Dr. SHARES IN X, LTD. *Cr.*

			Nom £	£				Nom £	£
1952 Dec. 1	To Broker: Loan .		100	200	1953 Feb. 28	By Balance . .	c/d	100	80
						,, Loss . . .			120
			£100	£200				£100	£200
1953 Mar. 1	To Balance . .	b/d	100	80					

The foregoing accounts, if opened, will displace the detailed Joint Venture Account so far as shares are concerned, the profit or loss thereon being transferred to the Joint Venture Account which will then be—

Dr. JOINT VENTURE *Cr.*

		£	s.	d.			£	s.	d.
To Loss on Shares—					By Profit on Shares—				
B, Ltd. . .		27	0	0	A, Ltd. . .		155	0	0
R, Ltd. . .		208	0	0	,, Loss . .	c/d	200	0	0
X, Ltd. . .		120	0	0					
		£355	0	0			£355	0	0
To Loss . . .	b/d	200	0	0	By Dividends—				
,, Broker's Interest .		1	7	9	A, Ltd. £36 (*less* £24 credited to Assets) . £12				
					X, Ltd. . 7				
					B, Ltd. . 58		77	0	0
					,, Loss . .		124	7	9
		£201	7	9			£201	7	9

The balances on the separate Shares Accounts must be equal to that appearing in the Joint Venture Account constructed by the first method.

CHAPTER XVII

CONSIGNMENT ACCOUNTS

It is a common practice of exporters to dispatch goods to representatives abroad for the purpose of sale. The knowledge possessed by the agent of local conditions, the availability of the goods for the foreign customer by reason of the present possession of stock in the foreign agent's warehouse, and many other reasons, form a strong inducement to the exporter to enter into an arrangement with a reliable local trader whereby the latter will receive goods for sale on behalf of the exporter.

Goods forwarded by an exporter to his agent for the purpose of warehousing and ultimate sale are described as a consignment, the sender of the goods being called the consignor and the recipient the consignee. Alternatively, the parties concerned are often respectively designated principal and agent.

Such a dispatch of goods, from the point of view of the consignor, is called a Consignment Outwards; from that of the consignee, a Consignment Inwards.

At periodical intervals, the consignee renders to his consignor a statement showing the goods received, sales, expenses incurred, commission charged, and remittances made, with the resultant balance due by him. This is called an Account Sales.

Illustration. H. Andrews, of Manchester, consigned 40 cases of goods to his agent, H. Butler, of Sydney, per S.S. *San Pedro*, invoiced at £15 per case, and drew a bill at 90 days for £400. An Account Sales was received in due course from the consignee showing gross proceeds of sale £880 made up of 30 cases at £20 each and 10 at £28 each. He deducted the following items: Dock dues, £15; Marine Insurance, £7 4s.; Storage, £18; Import Duty, £30; Commission, 5 per cent and 1 per cent *del credere* on sales. Show the Account Sales submitted to H. Andrews by H. Butler in respect of the above consignment. (See page 337.)

It is of considerable importance to observe that a consignment is not in the nature of a SALE by the consignor, nor of a PURCHASE by the consignee. It is clear that mere removal of goods from one department to another does not make a sale, and whether the removal is a matter of yards or miles it does not alter the significance of the transaction. It is usual to send to the consignee a memorandum, called a *pro forma* invoice, but this merely serves as a guide to the consignee unless, indeed, it is an actual instruction to sell at the price indicated in the invoice. For similar reasons a consignment does not come under the heading of "Goods on Sale or Return," "Hire Purchase," or "Forward Sale." It is, then, merely a transfer of goods from

one place to another with a view to the sale by the recipient on behalf of the sender.

ACCOUNT SALES of 40 cases of Goods ex S.S. *San Pedro*, sold for account of H. ANDREWS, Manchester, by

H. BUTLER,
10 OLD BAILEY STREET,
SYDNEY.

Marks and Number		£	s.	d.	£	s.	d.	£	s.	d.
	30 Cases at £20 per case							600	0	0
	10 ,, at £28 ,, ...							280	0	0
								880	0	0
	Less—									
	Dock Dues . .	15	0	0						
	Import Duty .	30	0	0						
	Marine Insurance .	7	4	0						
	Storage . .	18	0	0						
					70	4	0			
	Commission— 5% of £880 .	44	0	0						
	Del Credere— 1% of £880 .	8	16	0						
					52	16	0			
								123	0	0
								757	0	0
	Less Draft accepted against Consignment .							400	0	0
	Balance due to H. Andrews							£357	0	0

E. & O.E.
Sydney. (Signed)......*H. Butler*......
Date............

The consignee is entitled to be reimbursed for his legitimate expenditure, and to be paid his remuneration, it being clear that the consignee is neither a buyer nor a seller on his own account: consequently, the remuneration is his reward for services rendered to his consignor. The remuneration, which is termed commission, is usually calculated upon the total value of goods sold by the consignee. An additional commission, called *del credere* commission, is paid where the consignee agrees to meet any loss which the consignor may suffer by reason of bad debts. It must be noted that arrangements are frequently made whereby the consignee is paid on a percentage of profits.

CONSIGNOR'S BOOKS

The object of the book entries relating to Consignments Outwards is to ascertain the NET profit or NET loss on each separate consignment, and to transfer this figure to a Profit and Loss on Consignment Account.

A special account is opened to ascertain the profit or loss on each consignment, headed Consignment to — Account; thus if the

consignment is sent to B, Bombay, the account will be headed Consignment to B, Bombay.

The Consignment Account is not a *personal* Account but a *nominal* account; it is, in fact, a special Trading and Profit and Loss Account. It is important that the nature of this account be clearly grasped, because the principles applied to Trading and Profit and Loss Accounts are applicable to Consignment Accounts. The consignee is not the consignor's *debtor* for the goods (either at sale or cost price), the relationship of the parties being respectively Agent and Principal as distinct from Purchaser and Vendor.

Usually the Consignment Account is debited with the goods at cost[1] price and a Goods on Consignment Account credited; the balance of the latter account at the end of the accounting period being transferred in total to the credit of Purchases Account, or, alternatively, direct to the Trading Account.

All the expenses incurred by the consignor in respect of the consignment are debited to the Consignment Account and credited to cash or creditors, according to whether the expense is a cash or credit transaction. If the consignment expenses have been posted to the different expenses accounts, they will be transferred therefrom to the debit of the Consignment Account.

Upon receipt of the Account Sales from the consignee, a Personal Account is opened for him. The consignee owes to the consignor the proceeds of the sale, less any expenses (including commission) that he has properly incurred in respect of the particular consignment. Accordingly, the GROSS proceeds of the sale are debited to the Personal Account of the consignee and credited to the Consignment Account, or the net figure (i.e. the gross proceeds, less expenses) may be debited to the account of the consignee and credited to the Consignment Account. The latter method, however, is emphatically not recommended, because the true sales and expenses are not disclosed. Where the consignee remits a bill or draft in final settlement of the balance due, his Personal Account will be credited, and Bills Receivable or Bank debited. It must not be inferred that the consignee always remits in full the balance due to his consignor, and it may happen at any particular date that the consignee's Personal Account is not "in balance," but as it is an ordinary Personal Account the student is not likely to be confronted with any difficulty in his treatment of it. If the consignee has not remitted the balance due by him in FULL, but only in PART, he will be a *debtor*, whereas if he has remitted MORE than the balance due by him he will be a *creditor*. In practice, considerable difficulties arise by reason of the failure of the parties to "clear" each consignment as and when closed, particularly when the consignee remits round sums from time to time.

[1] The consignor may, however, have charged the goods to the Consignment Account at SELLING PRICE. The treatment arising therefrom is shown on page 346.

The Consignment Account will now contain on the debit side: (*a*) the cost[1] price of the goods, and (*b*) all the expenses relevant to the consignment, and on the credit (*a*) the Total Sales and (*b*) the Stock on Hand, if any, which will either be brought down as a balance on the debit of the Consignment Account for the succeeding period or be transferred to the debit of Consignment Stock Account (the second procedure being analogous to that pursued in the case of the Trading Account). The balance now standing on the account represents the profit or loss on the consignment. If a profit has resulted, it will be entered on the debit side, and transferred to the credit of Profit and Loss on Consignment Account; if a loss has ensued, it will be entered on the credit side and transferred to the debit of Profit and Loss on Consignment Account. The balance of the latter will be transferred to the General Profit and Loss Account at the end of the accounting period.

Finally, it must be noted that where transactions with the consignee are numerous, it is usually advisable to open separate accounts duly referenced for each consignment so as to avoid the confusion which is likely to arise by consolidating all the consignments in one account.

COST PRICE METHOD

Summary of Entries. Before proceeding with an example it is proposed to give a summary of the entries appropriate to Consignment Accounts, namely—

I. Debit Consignment Account with the cost price of the goods, and credit Goods on Consignment Account.

II. Debit Consignment Account with all expenses paid by the consignor in respect of the consignment and credit cash, creditors or expenses accounts.

III. When the Account Sales is received from the consignee, two entries are made, viz.—

(*a*) Debit consignee, credit Consignment Account with TOTAL SALES.

(*b*) Debit Consignment Account, credit consignee with all expenses incurred by the consignee and with his commission.

IV. Credit Consignment Account with Stock on Hand, and

(*a*) bring down as a balance *or*

(*b*) debit Consignment Stock Account.

V. Transfer the balance of the Consignment Account to Profit and Loss on Consignment Account and the balance of that account to General Profit and Loss Account.

VI. Debit the balance of Goods on Consignment Account and credit

(*a*) Purchases Account *or*

(*b*) Trading Account.

VII. Credit consignee, debit Cash or Bills Receivable with remittances received from the consignee.

[1] See page 338, *note*.

Illustration. C. Cotton, of Manchester, on 3rd January consigns goods, costing £1,000, to R. Rajah, his foreign agent. C. Cotton pays the following expenses on the same date, viz.: Marine Insurance, £20; Carriage and Freight, £70. R. Rajah is entitled to a 5 per cent selling commission and a 1¼ per cent *del credere* commission. In due course R. Rajah sends his Account Sales, which shows that he has sold goods for £1,600 and paid expenses amounting to £120; the expenses were paid on 4th February and the sale effected on 12th February. Stock in consignee's hands on 28th February, £30.

With the Account Sales, R. Rajah encloses a sight draft for the net amount due to C. Cotton. Show accounts of the consignment at 28th February in the books of the consignor.

Dr GOODS ON CONSIGNMENT *Cr.*

				19 . Jan 3	By Consignment to R. Rajah .		£ 1,000[1]

Dr CONSIGNMENT TO R RAJAH *Cr*

19..			£	19 .			£
Jan. 3	To Goods on Consignment . .		1,000	Feb 12	By R. Rajah—Sales—per Account Sales . . .		1,600
	,, Cash—Insurance .		20	28	,, Stock . .	c/d	30
	Carriage and Freight		70				
Feb. 4	,, R. Rajah—Expenses . .		120				
12	Commissions .		100				
28	,, Profit and Loss on Consignment Account . . .		320				
		£	1,630			£	1,630
Mar 1	To Stock .	b/d	30				

Dr. PROFIT AND LOSS ON CONSIGNMENT *Cr.*

				19 Feb 28	By Consignment to R Rajah . .		£ 320[2]

Dr. R. RAJAH *Cr*

19..			£	19 .			£
Feb. 12	To Consignment to R Rajah—Sales . . .		1,600	Feb. 4	By Expenses . . .		120
				12	,, Commissions . .		100
				28	,, Draft . . .		1,380
			£1,600				£1,600

It should now be clear that the Consignment Account is a Profit and Loss Account, whilst the Consignee's Account is a Personal Account to which the ordinary principles of book-keeping apply.

[1] Subsequently transferred to the credit of Purchases or Trading Account

[2] Subsequently transferred to the credit of General Profit and Loss Account.

Should there be a large number of consignments, the consignor will almost invariably employ a special Day Book and Ledger. In the Day Book (called the Consignments Day Book) will be entered the cost price of the goods sent on consignment (and, if necessary, a memorandum column therein will show the *pro forma* invoice price). From the Day Book the cost price of the consignment will be debited to the Consignment Account in question. The total of such Day Book will be periodically posted to the credit of Goods on Consignment Account. The memorandum column may also be totalled, but it forms no part of the double entry.

VALUATION OF UNSOLD STOCK

Where all the goods have not been sold it is necessary to value the unsold stock when preparing the Balance Sheet of the consignor. The valuation will be at cost price or local market price, if lower, and to the *former* figure must be added the non-recurring expenses, such as freight, insurance, duties, etc., the total of these expenses being apportioned between stock on hand and goods sold. It should be emphasized, however, that if the cost price (with the addition mentioned) exceeds the local market price, the latter must be taken as the basis of valuation.

Regarding the choice of cost or market value reference to the dates and prices of recent sales will afford some guide; whilst other factors might materially alter valuations, e.g. devaluation of currency.

If the goods have a poor market at the local establishment it may be advisable to transfer them to another establishment offering better prospects, thus involving cost of transport, further duties, and possibly deterioration through climatic or other causes, so that the values may have to be adjusted accordingly, regard being had to local selling price (if lower than the adjusted value).

If goods are in transit or in "risk" areas they should be taken into account at a value not exceeding the insured value.

Illustration. G. Britain consigns 1,000 units of goods to H. Kong, the cost price of which is £800. G. Britain pays expenses—

1. Carriage	£200
2. Marine Insurance	80
3. Freight	90

and H. Kong has incurred expenses to date of—

4. Carriage from Docks to Consignee's Warehouse	£15
5. Import Duty	45
6. Carriage to the Buyer's Warehouse	50
7. Commission	8
8. Expenses on goods sold	5

At a date when 600 units of the stock have been sold, it is required to balance off the Consignment Account, and accordingly the stock remaining must be carried down, being valued as shown on page 342.

Only the items (1) to (5) may be described as being attachable to the whole of the goods, and accordingly four-tenths (i.e. the ratio of the unsold stock to the total stock consigned) of these expenses are carried down with the stock in one figure.

The amount to be carried down is £492 arrived at as follows—

$\frac{4}{10} \times$ (£800 + 430) = £492, i.e. 400 units at 16s. per unit (£320) plus $\frac{4}{10}$ of £430 (£172).

Another way of stating the rule is this: that the stock on hand at the end of the accounting period of the consignor must be evaluated at the lower of current local market price or cost, as understood in a special sense, viz., by the inclusion of a proportionate part of all expenses incurred in respect of the *whole* consignment and not being of a RECURRING nature, such as Selling expenses. Therefore, in order to arrive at true cost one must add to cost such proportion of the "all in" expenses that the UNSOLD stock bears to the WHOLE stock; or what amounts to the same thing, the valuation of the stock is the remaining stock divided by original stock multiplied by the *whole* cost of the consignment.

Illustration. 100 units are consigned at £1 each. Expenses paid by the consignor are £20; by the consignee (applicable to the whole consignment) £30; 75 units of the goods are sold by the agent for £250, his commission being 6 per cent on sales.

Show the Consignment Account as it appears in the consignor's books.

Dr. CONSIGNMENT ACCOUNT *Cr.*

			Units	£	s.	d.				Units	£	s.	d.
	To Goods on Consignment Account		100	100	0	0		By Consignee: Sales per Account Sales		75	250	0	0
	„ Expenses			20	0	0		„ Stock [1]	c/d	25	37	10	0
	„ „			30	0	0							
	„ Commission 6% on £250			15	0	0							
	„ Profit and Loss on Consignment Account			122	10	0							
			100	£287	10	0				100	£287	10	0
	To Stock	b/d	25	37	10	0							

If the current market price is less than £37 10s. the former valuation would be substituted for that shown above.

[1] i.e. $\frac{25}{100} \times$ £100 = £25 (£1 per unit) plus $\frac{25}{100} \times$ £50 = £12 10s. Total, £37 10s. *or* $\frac{25}{100} \times$ £150 = £37 10s. The "all in" cost per unit is 30s. [i.e. $\frac{150}{100}$ of 20s.] hence the value of Stock at cost is 25 units at 30s. each = £37 10s.

Loss of Stock. Where some of the goods are lost or damaged, the entries to adjust the position in the books will depend upon whether the loss has been insured against or not. If the goods have been insured against loss or damage, the loss (without taking into account any anticipated profit) will be credited to Consignment Account and debited to Insurance or Underwriter's Account. In cases of this type, care must be taken in arriving at the value of the stock carried down, as the expenses relating thereto must be added to the cost in the proper proportion.

The valuation of the remaining goods in case of goods lost will be made up of two parts as follows—

(1) Proportion of the cost of the goods, plus expenses incurred on all goods.

(2) Proportion of the expenses incurred subsequent to loss.

As to (1) this proportion will be the remaining goods divided by the total goods consigned.

As to (2) this proportion will be the remaining goods divided by the total goods saved.

Illustration. 100 bales of goods are consigned (value £500) and 5 bales are damaged by fire and rendered worthless, a claim being made therefor against the insurance company.

The expenses may be summarized as follows—

Prior to Loss	Subsequent to Loss	
Non-recurring	*Non-recurring*	*Selling*
£	£	£
80	190	300

Up to the end of the accounting period 55 bales had been sold for £700.

Show Consignment Account in the books of the consignor.

Dr. CONSIGNMENT ACCOUNT *Cr.*

19..		Bales	£	19..		Bales	£
	To Cost of Goods	100	500		By Sales	55	700
	„ Expenses prior to Loss		80		„ Insurance Claim Account	5	29
	„ Expenses subsequent to Loss		190		„ Stock c/d	40	312
	„ Selling Expenses		300		„ Transfer to Profit and Loss on Consignment Account: Loss		29
		100	£1,070			100	£1,070
	To Stock b/d	40	312				

The claim against the insurer for £29 is made up—

Cost of Goods = $\frac{5}{100} \times$ £500	£25
Expenses prior to Loss = $\frac{5}{100} \times$ £80 =	4
	£29

The Stock value of £312 is arrived at—

		£	£	
Cost of Goods	$\frac{40}{100} \times$ £500 =	200		
Expenses prior to Loss	$\frac{40}{100} \times$ £80 =	32		
			232	(per rule 1)
Expenses subsequent to Loss	$\frac{40}{95} \times$ £190 =		80	(per rule 2)
			£312	

The result may be more clearly explained by opening two separate accounts as follows—

(*a*) Consignment Account (I) showing goods lost.
(*b*) Consignment Account (II) showing saleable goods.

Dr. CONSIGNMENT ACCOUNT (I) *Cr.*

19..		Bales	£	19..		Bales	£
	To Cost of Goods . .	5	25		By Insurance Claim Account . .	5	29
	„ Expenses prior to Loss[1] . . .		4				
		5	£29			5	£29

Dr. CONSIGNMENT ACCOUNT (II) *Cr.*

19..		Bales	£	19..		Bales	£
	To Cost of Goods. .	95	475		By Sales . .	55	700
	„ Expenses prior to Loss . . .		76		„ Stock[2] . c/d	40	312
	„ Expenses subsequent to Loss . .		190		„ Transfer to Profit and Loss on Consignment Account: Loss .		29
	„ Selling Expenses .		300				
		95	£1,041			95	£1,041
	To Stock . . b/d	40	312				

Where the loss is not insured against, it must not be left to adjust itself in the Consignment Account by merely inserting the stock as reduced by the loss, but, as the consignor is bearing his own insurance, the loss should be dealt with by crediting Consignment Account as if the stock actually existed, and debiting Uninsured Loss Account. This method has the additional advantage of permitting comparison of the results of several consignments as shown by the Consignment Accounts (as the abnormal loss has been eliminated). The entries necessary to adjust such a loss in the above circumstances are the same as where the loss has been insured against, except that the amount of loss is carried to the debit of Uninsured Loss Account instead of to the Insurance Claim Account.

Loss Due to Natural Causes. Where the loss is due to natural causes, e.g. evaporation, the amount of stock to be carried down is the proportion of the total cost that the number of units on hand bears to the total number of units as diminished by the loss.

[1] $\frac{5}{100} \times$ £80.
[2] i.e. $\frac{40}{95} \times$ £741, as ALL these expenses have reference to the 95 bales.

Illustration. 100 tons consigned, costing £200; 5 tons loss due to weighing, carting, etc.; 38 tons in hand. The stock in hand is therefore valued $\frac{38}{95} \times £200 = £80$.

Deficiency of Stock. Where there is a deficiency of stock at stocktaking, and the consignee is under a liability to account for the value of the missing stock, the following entry will be made in the consignor's books—

Dr. Consignee. *Cr.* Consignment Account.

If, on the other hand, he is not liable, then the stock will be brought in at the gross figure (the amount it ought to be) and the deficiency debited to Consignment Account, only the actual stock figure being brought down. Alternatively, the closing stock will be brought in at the reduced figure automatically giving effect to the deficiency, e.g. if the stock ought to be £400, and there is a shortage of £50, the credit to Consignment Account will be £350 only, thus reducing the profit (or augmenting the loss) automatically by £50. This latter method is not recommended.

The entries are—

Dr. (1) CONSIGNMENT ACCOUNT[1] *Cr.*

			£				£
	To Goods . .		—		By Proceeds . . .		—
	„ Expenses . . .		—		„ Stock . . .		400
	„ Loss in Stock . .		50				
	To Stock . .	b/d	350				

or

Dr. (2) CONSIGNMENT ACCOUNT *Cr.*

							£
					By Stock . . .	c/d	350
	To Stock . .	b/d	350				

On no account must the deficiency of Stock be debited to Consignment Account, unless it is included in the closing stock on the credit side.

Where an allowance is given, say, for damage (the goods still being saleable) the expenses to be added to the remaining stock may be apportioned as shown in the following illustration.

Illustration. Goods worth £1,000 are sent to Y on consignment; expenses, other than Selling Expenses of 5 per cent on sales, being £100. £500 of the goods are received in a damaged condition, the consignor making an allowance of £300. Sales by the consignee are £400 (cost £250), and the damaged goods are disposed of for £210. Show the treatment of the end stock.

[1] The figures are confined to the point under discussion.

The value of the closing stock will be the cost price plus a proportion of expenses. Expenses may be apportioned—

(1) In the ratio that unsold stock bears to the revised value of goods consigned: $\frac{250}{700} \times £100 = £35$ 14s. 3d.

(2) In the ratio that undamaged stock unsold bears to the total undamaged goods consigned: $\frac{250}{500} \times £100 = £50$.

Method (1) is probably preferable, for the expenses are incurred in respect of the total consignment, and damaged goods must bear their proportion as well as undamaged goods.

If no ***damaged*** goods are sold, the proportion to be added to cost will be computed as follows—

Original value of Goods sent	£1,000
Less Allowance	300
∴ Revised value of Goods sent	£700

The damaged goods remaining	= £500 − 300 =	£200
The undamaged goods remaining	= £500 − 250 =	250
(i.e. £250 have been sold)	TOTAL =	£450

Proof—

Revised value of Goods	£700
Less Sales	250
Goods remaining	£450

The addition for Expenses will be (under method (1))—

$\frac{450}{700} \times £100$ (Expenses) . . . . £64 5s. 8d.

If the goods are considered in units rather than in bulk, each unit should bear its due proportion of expenses and the closing stock will be valued in accordance with the rules enunciated earlier in this chapter.

INVOICE PRICE METHOD

It is sometimes found that the goods sent on consignment are entered up in the books at the *pro forma* price; that is, they may be entered, either at the minimum price at which the consignee is entitled to sell the goods, or at the price which is considered by the consignee to represent a satisfactory profit on the goods. The actual price realized is not known by the consignor until the consignee renders the Account Sales.

Summary of Entries—Invoice Price Method. Where goods are invoiced at selling price the entries in the consignor's books are—

(1) Debit Consignment Stock Account and credit Goods on Consignment Account with consignment at SELLING PRICE.

(2) At the end of the accounting period—

Debit Goods on Consignment Account and credit Purchases Account with the *true* cost of the goods;

Debit Goods on Consignment Account and credit Consignment Stock Adjustment Account with the amount added to cost or, as it is termed, "Loading."

(3) The sales by the consignee will be debited to the consignee and credited to the Consignment Stock Account.

(4) The balance of stock on consignment will be credited at the SELLING price and brought down to the opposite side (like any other balance) on Consignment Stock Account.

(5) The "all in" expenses must be shown in a SEPARATE expenses account and apportioned in the ratio of the unsold stock to the stock sold; the amount apportionable to unsold stock must be carried forward and the balance transferred to Consignment Trading Account. The expenses may be debited direct to Consignment Trading Account and the amount apportionable to unsold stock brought down as a balance thereon.

(6) Debit the Stock Adjustment Account and credit the Consignment Trading Account with the REALIZED profit representing the excess of selling price over cost.

(7) Bring down the balance on Consignment Stock Adjustment Account (debit above the line: credit below the line) being the loading on REMAINING stock. This balance will, in the Balance Sheet, be deducted from stock at selling price shown in (4), plus (5). If the current market price is less than the cost, as shown by the excess of (4) and (5) over (7), a provision must be created by debiting Profit and Loss on Consignment Account and crediting Stock Provision, representing the depreciation of stock value.

(8) The balance of Profit and Loss on Consignment Account is transferred to the General Profit and Loss Account.

Illustration. A, of London, consigned 100 cases of goods (cost £750) to B, of Singapore, on 1st January, 19.., charging them up at a *pro forma* invoice price to show a profit of 25 per cent on sales. A paid at the same date £60 in respect of freight and insurance. On 22nd January, B paid expenses, £20, and on 29th January sold 80 cases of the consignment for £800. B is entitled to a commission on sales of 5 per cent, which he duly charged up.

The following are the accounts recording the transaction in the books of A, the consignor, the books being balanced on 30th January, 19...

Dr. GOODS ON CONSIGNMENT *Cr.*

19..			£	19..			£
Jan. 30	To Purchases (or Trading) Account .		750	Jan. 1	By Consignment Stock Account . .		1,000
	" Consignment Stock Adjustment Account . . .		250				
			£1,000				£1,000

Dr. CONSIGNMENT STOCK **Cr.**

			Cases	£				Cases	£
19.. Jan. 1	To Goods on Consignment Account .		100	1,000	19 Jan. 29	By B—(Consignee) Sales . .		80	800
					30	,, Stock . .	c/d	20	200
			100	£1,000				100	£1,000
Jan. 31	To Stock . .	b/d	20	200					

Dr. CONSIGNMENT TRADING ACCOUNT **Cr.**

				£					£
19 . Jan. 1	To Cash—Freight and Insurance .			60	19 . Jan 29	By Consignment Stock Adjustment Account . .			200
22	,, B—(Consignee) Expenses .			20	30	,, Expenses . $\frac{20}{100}$[£60 + £20]	c/d		16
29	Commission			40					
30	,, Profit and Loss on Consignment Account			96					
				£216					£216
Jan. 31	To Expenses .	b/d		16					

Dr. B (CONSIGNEE) **Cr.**

				£					£
19.. Jan. 29	To Consignment Stock Account—Sales			800	19 Jan. 22	By Consignment Trading Account—Expenses .			20
					29	Commission			40
					30	,, Balance .	c/d		740
				£800					£800
Jan. 31	To Balance. .	b/d		740					

Dr. CONSIGNMENT STOCK ADJUSTMENT ACCOUNT **Cr.**

			Cases	£				Cases	£
19 . Jan. 29	To Consignment Trading Account[1] .		80	200	19 . Jan. 30	By Goods on Consignment Account . .		100	250
30	,, Balance .	c/d	20	50					
			100	£250				100	£250
					Jan. 31	By Balance .	b/d	20	50

Dr. PROFIT AND LOSS ON CONSIGNMENT ACCOUNT **Cr.**

									£
					19. Jan. 30	By Consignment Trading Account . .			96

[1] i.e. 80 cases at £2 10s. each.

The stock brought down will be shown in the Balance Sheet as follows—

	£
Consignment Stock	200
Trading Account (Expenses b/d) . .	16
	216
Less Stock Adjustment Account . .	50
	£166

MEMORANDUM COLUMN METHOD

It is important to note that, wherever practicable, and most certainly in examinations where no other method is specifically called for, the memorandum column method should be employed.

Illustration. With particulars identical to those set out in the preceding illustration, the accounts under this method appear as follows—

Dr. CONSIGNMENT STOCK *Cr.*

			Cases	*Memo.*					Cases	*Memo.*	
				£	£					£	£
19.. Jan. 1	To Goods on Consignment Account .		100	1,000	750	19.. Jan. 29	By B (Consignee) .		80	800	800
30	,, Consignment Trading Account				200	30	,, Stock .	c/d	20	200	150
			100	£1,000	£950				100	£1,000	£950
Jan. 31	To Stock .	b/d	20	200	150						

Dr. CONSIGNMENT TRADING ACCOUNT *Cr.*

			£				£
19.. Jan. 1	To Cash— Freight and Insurance . . .		60	19.. Jan. 30	By Consignment Stock Account . .		200
22	,, B: (Consignee)— Expenses . .		20		,, Expenses $\frac{1}{5}$ (£60 + £20) . . .	c/d	16
29	,, B: Commission .		40				
30	,, Profit and Loss on Consignment Account.		96				
			£216				£216
Jan. 31	To Expenses. . .	b/d	16				

Dr. B (CONSIGNEE) *Cr.*

			£				£
19.. Jan. 29	To Consignment Stock Account— Sales . . .		800	19.. Jan. 22	By Consignment Trading Account— Expenses . .		20
				29	Commission . .		40
				30	,, Balance . . .	c/d	740
			£800				£800
Jan. 31	To Balance . . .	b/d	740				

Dr. GOODS ON CONSIGNMENT *Cr.*

			Cases	*Memo.* £	£				Cases	*Memo.* £	£
19.. Jan. 30	To Purchases or Trading Account .		100	£1,000	£750	19.. Jan. 1	By Consignment Stock Account		100	£1,000	£750

The Consignment Account would appear (if charged up at cost) as follows—

Dr. CONSIGNMENT ACCOUNT (*abbreviated*) *Cr.*

			Cases	£				Cases	£
	To Goods, etc. .		100	750		By Sales . . .		80	800
	„ Expenses . .			60		„ Stock. . . [$\frac{20}{100}$ × £830]	c/d	20	166
	„ „ . .			20					
	„ Selling Commission . .			40					
	„ Profit and Loss on Consignment Account			96					
			100	£966				100	£966
	To Stock . . .	b/d	20	166					

Illustration. On 5th March, 19.., X consigns 200 gramophones to Y, costing £15 each. The *pro forma* invoice is made out to him at a figure to show a *gross* profit of 20 per cent on sales, below which figure the consignee Y is not permitted to sell. On 25th March the consignee sells half the consignment at a profit of 25 per cent on sales. The expenses were as follows—

Mar. 5. Freight and Insurance . . £50 (paid by consignor)
20. Landing Charges, including Import Duties . . . £50 (paid by consignee)

The consignee is entitled to a commission of 5 per cent on sales and to one-sixth of the profits after charging up both commission and share of profits. On 31st March, 19.., Y remits a sight draft —the balance on his account having been agreed—to settle his account.

Show the entries in the books of X, the consignor.

Dr. Y (CONSIGNEE) *Cr.*

			£				£
19.. Mar. 25	To Consignment to Y Account— Sales . . .		2,000	19.. Mar. 20	By Consignment to Y Account— Landing Charges, etc. . . .		50
				25	Commission . .		100
				31	Share of Profits .		50
					„ Sight Draft . .		1,800
			£2,000				£2,000

Dr. **Goods on Consignment** *Cr.*

			Units	Memo.					Units	Memo.	
				£	£	19..				£	£
						Mar. 5	By Consignment to Y Account . .		200	3,750	3,000

Dr. **Consignment to Y** *Cr.*

			Units	Memo.					Units	Memo.	
19..				£	£	19..				£	£
Mar. 5	To Goods on Consignment Account .		200	3,750	3,000	Mar. 25	By Y (Consignee)— Sales . . .		100	1,875	2,000
	„ Bank—Freight and Insurance . .				50	31	„ Stock . . . i.e. $\frac{1}{2} \times$ £[3,000 + 50 + 50]	c/d	100	1,875	1,550
20	„ Y (Consignee)— Landing Charges, etc. . . .				50						
25	Commission . .				100						
31	Share of Profit. .				50						
	„ Profit and Loss on Consignment Account .				300						
			200	£3,750	£3,550				200	£3,750	£3,550
Apr. 1	To Stock . . .	b/d	100	1,875	1,550						

Dr. BANK *Cr.*

			£				£
19.. Mar. 31	To Y (Sight Draft) .		1,800	19.. Mar. 5	By Consignment to Y Account— Freight and Insurance . . .		50

Dr. PROFIT AND LOSS ON CONSIGNMENT ACCOUNT *Cr.*

							£
				19 . Mar. 31	By Consignment to Y Account . .		300

Note. Y, the consignee, is entitled to 5 per cent on sales, i.e. 5 per cent on £2,000 = £100; and one-sixth of £300 [i.e. one-seventh of £350].

Consignor's Books—Alternative Entries. The following procedure may be adopted in dealing with the closing stock in the consignor's books—

(1) The closing stock is credited to the Consignment Account and brought down in the usual way.

(2) The closing stock is debited to Goods on Consignment Account and brought down as a credit balance.

(3) The effect, therefore, is to eliminate the stock balance on the Consignment Account and to reduce the credit to Purchases Account, i.e. the General Purchases Account of the business only shows a reduction to the extent of the Goods on Consignment actually sold; consequently, the General Trading Account must include the **cost price** of the unsold Stock on Consignment.

(4) The loading for carried forward expenses is brought down as a debit balance on Goods on Consignment Account.

In short, the unsold Stock on Consignment is considered as general stock, since the reduced credit to Purchases from Goods on Consignment Account, as it were, brings back into the General Trading Account such unsold stock, and hence it must be included in the stock figure in the General Trading Account.

Illustration. A consigns to B 100 units of goods (costing £1,000) and pays expenses, £50. B sells 60 units for £700, landing expenses being £20. B is entitled to a selling commission of 5 per cent.

Show the treatment of end stock in the books of the consignor.

Dr. CONSIGNMENT TO B *Cr.*

		Units	£			Units	£
	To Goods on Consignment Account .	100	1,000		By B—Sales . .	60	700
	,, Cash—Expenses .		50		,, Stock . . c/d	40	428
	,, B—Expenses . .		20				
	,, B—Commission .		35				
	,, Profit and Loss on Consignment Account		23				
		100	£1,128			100	£1,128
	To Stock . . b/d	40	428				

Dr. GOODS ON CONSIGNMENT *Cr.*

			£				£
	To Stock	c/d	428		By Consignment to B Account		1,000
	„ Purchases (or Trading) Account		600		„ Expenses prepaid	c/d	28
			£1,028				£1,028
	To Expenses prepaid	b/d	28		By Stock	b/d	428

Dr. STOCK ON CONSIGNMENT *Cr.*

			£				
	To Trading Account		400				

The Trading Account will have been credited with £600 only, and therefore stock of £400 will have to be credited to Trading Account and debited to Stock on Consignment Account.

This item, "Stock on Consignment," will be shown as an asset on the Balance Sheet of the consignor, as also will be the item of "Expenses prepaid" in respect of this stock. If, when the Consignor's Accounts are being drawn up, it is found that a considerable loss has resulted on the consignment to date, it may be necessary to create a provision against a similar loss resulting on the remaining portion of the goods unless the realized loss is due to some abnormal cause. Further, if the market value is less than the cost price plus the expenses, it will be necessary to introduce such lower figure into the books.

Where goods are invoiced at selling price it by no means follows that the consignee's sales will exactly produce such a price. As, however, the Consignment Stock Account is built up on the basis of precise selling price, any difference between the "charge up" price to the consignee and the actual realization must be transferred to Consignment Trading Account, which will increase the profit in the event of an "excess" realized price, and conversely for a "deficient" realized price. There will, therefore, be three separate elements in the Consignment Trading Account, viz.—

(1) Profit on the stock realized, representing the excess of the "charge up" price over the cost.

(2) Profit or loss, representing excess or deficiency between realized price and "charge up" price.

(3) Expenses.

Illustration. A buys 100 cases costing £1 each and consigns them to his agent at $33\frac{1}{3}$ per cent on selling price. The agent sells 60 cases at a profit of 5 per cent on the cost to him. A pays expenses amounting to £100; and the agent's commission amounts to £9.

Show the Ledger Accounts in the books of the consignor.

Invoice Price Method.

Dr. CONSIGNMENT STOCK *Cr.*

Date			Cases	£	s	d	Date			Cases	£	s	d
	To Goods on Consignment Account		100	150	0	0		By Sales[1]		60	94	10	0
	,, Consignment Trading Account[1]			4	10	0		,, Stock	c/d	40	60	0	0
			100	£154	10	0				100	£154	10	0
	To Stock	b/d	40	60	0	0							

Dr. GOODS ON CONSIGNMENT *Cr.*

Date			£	s	d	Date			£	s	d
	To Purchases (or Trading) Account		100	0	0		By Consignment Stock Account		150	0	0
	,, Consignment Stock Adjustment Account		50	0	0						
			£150	0	0				£150	0	0

Dr. CONSIGNMENT TRADING ACCOUNT *Cr.*

Date			£	s	d	Date			£	s	d
	To Expenses[2]		100	0	0		By Consignment Stock Account— Profit on Consignment Stock[1]		4	10	0
	,, Consignee's Commission[2]		9	0	0		,, Consignment Stock Adjustment Account— Profit on "charge up" price[3]		30	0	0
							,, Proportion of Expenses[2]	c/d	40	0	0
							,, Profit and Loss on Consignment Account		34	10	0
			£109	0	0				£109	0	0
	To Expenses	b/d	40	0	0						

Dr. CONSIGNMENT STOCK ADJUSTMENT ACCOUNT *Cr.*

Date			£	s	d	Date			£	s	d
	To Provision on Unsold Stock	c/d	20	0	0		By Goods on Consignment Account		50	0	0
	,, Consignment Trading Account— Profit on Stock realized		30	0	0						
			£50	0	0				£50	0	0
							By Provision	b/d	20	0	0

[1] If the goods were sold at the precise loaded price, this would be 60 at 30s., i.e. £90. They were sold at £90 plus 5 per cent thereon, realizing £94 10s; therefore £4 10s. is the "excess" profit, transferred to Consignment Trading Account.

[2] These items could be shown on a separate Expenses Account, and the balance of £69 only transferred.

[3] 50% of £60, or 33⅓% of £90.

Dr. CONSIGNEE Cr.

		£	s.	d.			£	s.	d.
To Consignment Stock—Sales . . .		94	10	0	By Consignment Trading Account: Commission .		9	0	0
					,, Balance . .	c/d	85	10	0
		£94	10	0			£94	10	0
To Balance . .	b/d	85	10	0					

The Balance Sheet will show Consignment Stock £80, made up as follows—

	£
Consignment Stock	60
Consignment Expenses	40
	100
Less Consignment Stock Adjustment Account	20
	£80

If the ordinary procedure be adopted the Consignment Account and Goods sent on Consignment Account would in abbreviated form be as below (no difference arising in the case of the Consignee's Account).

Cost Price Method.

Dr. CONSIGNMENT ACCOUNT Cr.

		Cases	£	s.	d.			Cases	£	s.	d.
To Goods .		100	100	0	0	By Sales . .		60	94	10	0
,, Expenses .			100	0	0	,, Stock . .	c/d	40	80	0	0
,, Commission .			9	0	0	,, Profit and Loss on Consignment Account .			34	10	0
		100	£209	0	0			100	£209	0	0
To Stock[1] .	b/d	40	80	0	0						

Dr. GOODS ON CONSIGNMENT Cr.

		£	s.	d.			£	s.	d.
To Purchases (or Trading) Account		100	0	0	By Consignment Account . .		100	0	0

ALTERNATIVE ENTRIES

Dr. CONSIGNMENT STOCK Cr.

		Cases	£	s.	d.			Cases	£	s.	d.
To Goods on Consignment Account . .		100	100	0	0	By Sales . .		60	94	10	0
,, Consignment Trading Account[2] .			34	10	0	,, Stock . .	c/d	40	40	0	0
		100	£134	10	0			100	£134	10	0
To Stock . .	b/d	40	40	0	0						

[1] i.e. $\frac{40}{100}$ of £200.

[2] See note [1] on page 356.

Dr. GOODS ON CONSIGNMENT *Cr.*

			£	s.	d.				£	s.	d.
	To Purchases (or Trading) Account		60	0	0		By Consignment Stock Account . .		100	0	0
	" Stock. . .	c/d	40	0	0						
			£100	0	0				£100	0	0
							By Stock . . .	b/d	40	0	0

Dr. CONSIGNMENT EXPENSES *Cr.*

			£	s.	d.				£	s.	d.
	To Expenses . .		100	0	0		By Proportion of Expenses Forward	c/d	40	0	0
	" Commission .		9	0	0		" Consignment Trading Account[1] .		69	0	0
			£109	0	0				£109	0	0
	To Expenses[2] . .	b/d	40	0	0						

In this alternative method, the credit balance on Goods on Consignment cancels the debit on Consignment Stock Account and therefore, as £60 (instead of £100) has been transferred to the credit of purchases, the amount of stock MUST be brought into the General Trading and Profit and Loss Account as £40 or at market value if less.

The Balance Sheet will show Consignment Stock, £80, made up as follows—

	£
Consignment Stock Account	40
Consignment Expenses	40
	£80

It will be observed that the expenses per unit of stock are the same as the cost price per unit; hence the "carry-forward" will be the same.

Memorandum Column Method. Where the simple method of recording the selling price of the goods in a Memorandum column and of debiting the Consignment Account at cost price is employed, the accounts will in abbreviated form be as shown on page 357.

CORRECTION OF ERRORS

Many questions in examinations involve the correction of errors in connection with Consignment Accounts. They usually take the form of adjusting the position when goods sent on consignment have been (wrongly) debited against the *Personal* Account of the consignee, the cash being credited thereto either with or without a transfer being made to Profit and Loss Account.

[1] The Consignment Trading Account will show a final loss of £69 − £34 10s. = £34 10s. This is the identical result as shown on page 354.
[2] i.e. $\frac{40}{100}$ × £100.

Consignment Stock

Dr. | *Cr.*

		Cases	Nominal Selling Price	Cost Price					Cases	Nominal Selling Price	Actual Selling Price		
			£	£	s.	d.				£	£	s.	d.
To Goods		100	150	100	0	0	By Sales		60	90	94	10	0
„ Consignment Trading Account				34	10	0	„ Stock	c/d	40	60	40	0	0
		100	£150	£134	10	0			100	£150	£134	10	0
To Stock	b/d	40	60	40	0	0							

Consignment Trading Account

Dr. | *Cr.*

		£	s.	d.			£	s.	d.
To Expenses		100	0	0	By Profit on Consignment		34	10	0
„ Commission		9	0	0	„ Proportion of Expenses forward	c/d	40	0	0
					„ Profit and Loss on Consignment Account		34	10	0
		£109	0	0			£109	0	0
To Expenses	b/d	40	0	0					

The adjusting entries are—

(1) If goods have been debited AT COST PRICE—
Debit Sales Account.[1]
Credit Consignee for cost price of goods sent.

(2) If goods have been debited AT SELLING PRICE—
Debit Sales Account.[1]
Credit Consignee for selling price of goods sent.

(3) If goods have been debited AT COST PRICE and the consignee has been charged with PROFIT—
Debit Sales Account with the Cost.[1]
Debit Profit and Loss Account with the "Loading."
Credit Consignee for invoice price of goods sent.

In all the above instances the incorrect entries have been adjusted. These adjustments having been made, there remains in the Consignee's Account merely his original balance, if any, and the credit for the cash paid by him. The usual entries will then be made.

Illustration. The following Ledger Account is shown in the books of a consignor. Make the necessary adjustments.

Dr. CONSIGNEE *Cr.*

			£				£
To Goods	(1)		1,200	By Cash	(x)		600
,, Profit and Loss Account	(2)		250	,, Balance	(y)	c/d	850
			£1,450				£1,450
To Balance	(y)	b/d	850				

Adjusting entries, assuming the credit has been made to Goods on Consignment Account, will be—

(1) Debit Consignment Account, £1,200 Credit Consignee, £1,200
(2) Debit Profit and Loss Account, £250 Credit Consignee, £250

No entries are required in respect of x and y. As a result, the account of the consignee is—

Dr. CONSIGNEE *Cr.*

		£			£
To Balance (as above)	b/d	850	By Consignment Account		1,200
,, Balance	c/d	600	,, Profit and Loss Account		250
		£1,450			£1,450
			By Balance	b/d	600

The Consignment Account will now be in debit for £1,200, whilst the previous credit to Profit and Loss Account will be eliminated. The subsequent entries in the Consignment Account will be made in the usual way.

Illustration. A consigns goods to his agent at cost price £3,400. The agent's account in A's books is as follows—

Dr. AGENT *Cr.*

		£			£
To Goods		3,400	By Cash		2,800
,, Profit and Loss Account		430	,, Balance	c/d	1,030
		£3,830			£3,830
To Balance	b/d	1,030			

[1] If the original credit was to Goods on Consignment Account, Consignment Account must be substituted for Sales Account.

The agent sells the goods for £3,960, which exceeds by £850 the invoice prices. The agent collects £3,400. Discount allowed, £20; Bad Debts, £110; Expenses, £120. The agent is entitled to 5 per cent commission on **cash** collected. End stock to be valued at invoice price. Show the correcting entries in the consignor's books in ledger form.

The entries in the consignor's books are—

Dr. AGENT *Cr.*

		£			£
To Balance (as above)	b/d	1,030	*By Consignment Account*		*3,400*
,, Balance	c/d	2,800	*,, Profit and Loss Account*		*430*
		£3,830			£3,830
To Consignment Account: Sales		3,960	By Balance	b/d	2,800
			,, Consignment Account Discount		20
			Bad Debts		110
			Expenses		120
			Commission		170
			,, Balance	c/d	740
		£3,960			£3,960
To Balance	b/d	740			

Dr. CONSIGNMENT ACCOUNT *Cr.*

		£			Inv'ce Value £	£
To Agent: *Goods on Consignment*		*3,400*	By Sales		3,110	3,960
Discount		20	,, Stock	c/d	290	290
Bad Debts		110				
Expenses		120				
Commission (5% on £3,400)		170				
,, Profit and Loss Account		430				
		£4,250			£3,400	£4,250
To Stock	b/d	290				

Dr. PROFIT AND LOSS ACCOUNT *Cr.*

		£			£
To Agent[1]		*430*	By Balance	b/d	430
			,, Consignment Account		430

Note. Items in italics are reversing entries.

The two balances £(740 + 290) equal the original balance £1,030.

The profit can be checked as follows—

	£	£
Gross Profit [£3,960 *less* £3,110]		850
Less Discount	20	
Bad Debts	110	
Expenses	120	
Commission	170	420
Net Profit		£430

Where a Consignment Debtors' Account is employed the entries will be as on page 360, the other accounts remaining the same.

[1] Alternatively the transfer may be made by debiting Consignment Account and crediting agent.

Dr. AGENT **Cr.**

			£				£
	To Consignment Debtors .		3,400		By Balance (as before) .	b/d	2,800
					" Expenses . .		120
					" Commission . .		170
					" Balance . .	c/d	310
			£3,400				£3,400
	To Balance . .	b/d	310				

Dr. CONSIGNMENT DEBTORS **Cr.**

			£				£
	To Consignment Account		3,960		**By Agent** . . .		3,400
					" Discount . .		20
					" Bad Debts . .		110
					" Balances. . .	c/d	430
			£3,960				£3,960
	To Balance . . .	b/d	430				

These two accounts equal the amount shown against the agent on page 359, the only difference in entries being those shown in heavy type for receipts from debtors.

Examination Problem. When auditing the books of the M and A Tobacco Co., Ltd., you find the following account in the Sales Ledger—

Dr. H B **Cr.**

			£				£
19.. Sept. 1	To Invoice No. 1843 .		340	19.. Dec. 1	By Cash . .		100
				31	" Balance . . .	c/d	240
			£340				£340
19.. Jan. 1	To Balance . . .	b/d	240				

Reference to Invoice No. 1843 shows that the charge is—

	£
1 gross Straight Grain Briar Pipes	144
30 doz. Briar Pipes	180
25 lb. Smoking Mixture	25
	£349

This amount £349, *less* Estimated Drawback on Tobacco £9 equals £340.

On inquiry the following additional facts are ascertained—

(*a*) The pipes were purchased by the M and A Tobacco Co., Ltd., at 140s. per doz. Straight Grain and 70s. per doz. Briars. The Smoking Mixture cost 12s. per lb., including duty.

(*b*) On 1st September, 19.., H B, the assistant sales manager to the Company, went abroad with the goods as invoiced as a trial consignment to test the foreign market. He returned on 30th November, 19.., paying in the cash collected for cash sales made by him, viz., 80 Straight Grain, 51 Briars, and 8 lb. Smoking Mixture. Selling prices abroad were fixed at: Straight Grain, \$4; Briars, \$2; and Smoking Mixture, 50 cents per oz.

(*c*) Drawback on Export was received at 9s. per lb. on the Smoking Mixture and credited to Drawback Account.

(*d*) Further charges paid and debited to the ordinary Nominal Ledger Accounts were—

Freight (Carriage Outwards Account), £10; Insurance, £2; Foreign Warehouse Charges, £25. H B's salary, at the rate of £1,200 *per annum*, has all been charged to Salary Account, but it is decided to charge *one-half* of it against the venture. (Warehouse charges have been paid by H B.)

(*e*) H B made credit sales abroad as follows—

Straight Grains, 50; Briars, 75; Smoking Mixture, 17 lb.

These he reported on his return, but owing to a mistake they were credited to sales in the usual way. At the date of the audit all the amounts outstanding had been received, except £7 5s., which is found to be irrecoverable.

(*f*) Eight Straight Grain and 30 Briars were given away for advertising purposes and the balance of the stock was brought back to Head Office by H B.

You are asked to prepare the Consignment Account in the consignor's books, to rectify the incorrect entries, and to record the above transactions correctly in the books, showing the profit resulting. (Assume Rate of Exchange at 4·86 dollars to the £ throughout.)

(*Adapted from Institute of Chartered Accountants Final.*)

Dr H B *Cr.*

			£	s	d				£	s.	d
19 Dec 31	To Balance	b/d	240	0	0	19 Sept 1	By Sales		340	0	0
	„ H B Consignment Account—Sales		100	0	0		„ Foreign Warehouse Charges		25	0	0
	„ Cash		25	0	0						
			£365	0	0				£365	0	0

Dr. CONSIGNMENT DEBTORS *Cr.*

			£	s	d				£	s	d.
19 Dec 31	To Sales		100	0	0	19 Dec 31	By H B Consignment Account—Bad Debts		7	5	0
							„ Cash		92	15	0
			£100	0	0				£100	0	0

Dr. SALES *Cr.*

			£	s	d				£	s	d.
19 Sept 1	To H B		340	0	0	19 Sept 1	By H B [1]		340	0	0
Dec 31	„ H B Consignment Account	[2]	100	0	0	Dec. 31	„ Consignment Debtors		100	0	0
			£440	0	0				£440	0	0

Dr. PURCHASES *Cr.*

									£	s.	d
						19 Dec. 31	By Goods on Consignment Account		141	0	0

[1] Original entry to debit of H B. [2] Correcting entry to credit of H B.

Dr. **CONSIGNMENT TO H B** **Cr.**

Date		S.G. Briars (Quantities)	Briars (Quantities)	Mixture lb. (Quantities)	£	s.	d.
19.. Sept. 1	To Goods on Consignment Account[1]	144	360	25	204	0	0
	" Cash—						
	Carriage Outward				10	0	0
	Insurance				2	0	0
	" H B—						
	Foreign Warehouse Charges				25	0	0
Dec. 31	" Salaries				150	0	0
	" Consignment Debtors—						
	Bad Debts				7	5	0
		144	360	25	£398	5	0

Date		S.G. Briars (Quantities)	Briars (Quantities)	Mixture lb. (Quantities)	£	s.	d.
19.. Dec. 1	By H B: Cash Sales—$486[2]	80	51	8	100	0	0
31	" Cash: Drawback				11	5	0
	" Consignment Debtors—						
	Credit Sales—$486[2]	50	75	17	100	0	0
	" Gifts (a)	8	30				
	" Goods on Consignment Account—						
	Stock returned	6	204		63	0	0
	" Profit and Loss Account				124	0	0
		144	360	25	£398	5	0

[1]

		£
144 S.G. Briars at 140s. per doz.	=	84
360 Briars at 70s. per doz.	=	105
25 lb. Mixture at 12s. per lb.	=	15
		£204

[2]

Cash Sales		$
80 S.G. Briars at $4 each	=	320
51 Briars at $2 each	=	102
8 lb. mixture at $8 per lb. [i.e. 50 cents per oz.]	=	64
		$486
$486 at $4.86 to £	=	£100

Credit Sales		$
50 at $4	=	200
75 at $2	=	150
17 at $8	=	136
		$486
$486 at $4.86 to £	=	£100

Note (*a*). The cost of the gifts may be extended into the Sale Column with a contra entry in the money column for such expense.

Dr. GOODS ON CONSIGNMENT **Cr.**

Date	Particulars	S.G. Briars	Briars	Mixture lbs.	£	s.	d.	Date	Particulars	S.G. Briars	Briars	Mixture lbs.	£	s.	d.
19.. Dec. 31	To H B Consignment Account—Returns[1]	6	204		63	0	0	19.. Sept. 1	By H B Consignment Account	144	360	25	204	0	0
	" Purchases Account[2]	138	156	25	141	0	0								
		144	360	25	£204	0	0			144	360	25	£204	0	0

[1]

	£	s.	d.
6 S.G. Briars at 140s. per doz. =	3	10	0
204 Briars at 70s. per doz. =	59	10	0
	£63	0	0

[2]

	£	s.	d.
138 S.G. Briars at 140s. per doz. =	80	10	0
156 Briars at 70s. per doz. =	45	10	0
25 lb. mixture at 12s. per lb. =	15	0	0
	£141	0	0

PROFITS AND LOSSES ON EXCHANGE

In most cases where the consignee remits in foreign currency the problem of foreign exchange will enter into the accounts. The usual method is to adopt an arbitrary rate, and at the end of the consignment to deal separately with any profit or loss on exchange in order that the true result of the consignment may be ascertained. Accounts should be ruled with two columns, one for sterling as part of the double entry, and the other for foreign currency by way of memorandum.

The rules for treatment may be summarized thus—

(1) Where the consignee remits immediately at the close of the account, the profit or loss on exchange will be posted to Profit and Loss on Exchange Account and thence to Profit and Loss on Consignment Account, or *direct* to the latter account; or treated as a general Profit and Loss item.

(2) Where the consignee does not remit immediately at the close of the account, the profit or loss on exchange, being the difference between the arbitrary rate taken and the ruling rate, will be transferred to Profit and Loss on Exchange Account. Any profit or loss on exchange when the amount is actually remitted will similarly be transferred to Profit and Loss on Exchange Account, the final balance being transferred to Profit and Loss on Consignment Account.

(3) Under (2), where there is a profit on exchange at the close of the consignment, it is more prudent to credit the amount to an Exchange Reserve Account, to which account any subsequent profit or loss on exchange arising on the actual remittance will be posted, the final balance being transferred to Profit and Loss on Consignment Account.

(4) If the consignment is not completely disposed of at the date of the close of the consignor's accounting period, valuations of the balance of the Consignee's Account and of Stock will be required, the exchange position being dealt with as indicated in the foregoing paragraphs.

Illustration. D consigns goods to M, in Xland. The cost of the goods is £200, D paying expenses £30 and M 18,000 fcs. The latter sells all the goods for 112,500 fcs. and settles with a sight draft of 94,500 fcs., the rate of exchange being 480 fcs. to the £1. For the purposes of the accounts the other items are converted at an arbitrary rate of 450 to the £. Ignore commission. Show the accounts in D's books.

The important accounts will be as follows—

Dr. CONSIGNMENT TO M *Cr.*

	Fcs.	£	s.	d.		Fcs.	£	s.	d.
To Goods on Consignment Account	90,000	200	0	0	By M (Consignee): Sales	112,500	250	0	0
" Cash — Expenses	13,500	30	0	0	" Profit and Loss on Consignment A/c	9,000	20	0	0
" M (Consignee)— Expenses	18,000	40	0	0					
	121,500	£270	0	0		121,500	£270	0	0

Dr. M (CONSIGNEE) *Cr.*

	Fcs.	£	s.	d.			Fcs	£	s.	d.
To Consignment to M—Sales .	112,500	250	0	0	By Consignment to M—Expenses		18,000	40	0	0
					,, Draft .		94,500	196	17	6
					,, Loss on Exch'ge transferred to Profit and Loss on Exchange Account	[1]		13	2	6
	112,500	£250	0	0			112,500	£250	0	0

It will be observed that the English exporter expended £230 and finally received £196 17s. 6d., therefore losing £33 2s. 6d. in all.

Illustration. At the date of the completion of the consignment the rate was 440 fcs. to the £. M, however, withholds payment, and the rate depreciates to 500 to the £ before he remits. Show the accounts in D's books. (Calculate to the nearest £.)

Dr. M (CONSIGNEE) *Cr.*

		Fcs.	£			Fcs.	£
To Consignment to M—Sales .		112,500	250	By Consignment to M—Expenses		18,000	40
,, Profit on Exchange transferred to Profit and Loss on Exchange A/c	[2]		5	,, Balance . .	c/d	94,500	215
		112,500	£255			112,500	£255
To Balance .	b/d	94,500	215	By Draft . .		94,500	189
				,, Loss on Exchange transferred to Profit and Loss on Exchange A/c	[2]		26
		94,500	£215			94,500	£215

Dr. CONSIGNMENT TO M *Cr.*

	Fcs.	£		Fcs.	£
To Goods on Consignment Account .	90,000	200	By M (Consignee)—Sales	112,500	250
,, Cash—Expenses .	13,500	30	,, Profit and Loss on Consignment A/c .	9,000	20
,, M (Consignee)—Expenses . .	18,000	40			
	121,500	£270		121,500	£270

[1] The balance of this Account will be transferred to the debit of Profit and Loss on Consignment Account, leaving a final loss of £33 2s. 6d. (£20 + £13 2s. 6d.).

[2] See footnote on page 366.

Dr. PROFIT AND LOSS ON CONSIGNMENT ACCOUNT Cr.

		£		£
	To Loss on Consignment .	20	By Profit on Exchange[1] .	5
	„ „ „ Exchange[1] .	26	„ General Profit and Loss Account . . .	41
		£46		£46

It will be observed that the English exporter expended £230 and finally received £189, thus losing £41 in all.

Illustration. Assuming, in the above illustration, that the rate at the date of the completion of the consignment was 500 fcs. to the £ and 440 fcs. to the £ at the date of the remittance, show the Consignment Account and the Account of the Consignee in the book of the Consignor in abbreviated form. (Calculate to nearest £.)

Dr. CONSIGNMENT ACCOUNT (*abbreviated*) Cr.

		£		£
	To Goods	200	By Sales	250
	„ Expenses . . .	30	„ Loss . .	20
	„ „	40		
		£270		£270

Dr. M (CONSIGNEE) (*abbreviated*) Cr.

			Fcs.	£				Fcs.	£
	To Sales .		112,500	250		By Expenses—		18,000	40
						„ Profit & Loss on Exchange Account			21
						„ Balance .	c/d	94,500	189
			112,500	£250				112,500	£250
	To Balance .	b/d	94,500	189		By Draft . .		94,500	215
	„ Profit and Loss on Exchange Account			26					
			94,500	£215				94,500	£215

It will be observed that the English exporter expended £230 and finally received £215, thus losing £15 in all.

CONSIGNEE'S BOOKS

Entries in Consignee's Books. There are two recognized methods of dealing with Consignments Inwards, the first of which is the one more generally in use and is outlined below.

First Method. On receipt of the goods, the consignee will only make entries in respect thereof in his Stock Books. He will make no entries at all in the books of account, because the receipt is clearly not a purchase, as the goods are not the property of, but merely in the custody of, the consignee. If the consignee incurs any expenses in respect of the consignment, e.g. landing charges, import

[1]In order to save opening a Profit and Loss on Exchange Account, and transferring the balance to Profit and Loss on Consignment Account, the items marked thus have been posted direct to the latter account.

duties, warehousing and storing, etc., he will make the following entry—

Debit Consignor's Personal Account.
Credit Cash (or Creditors or Expenses).

As the goods are sold a memorandum entry will be made in the Stock Books.

When a sale is effected the entry is—

Debit Cash (or Debtors).
Credit Consignor's Personal Account.

The entries made will be exactly the same as those made for the ordinary sales of the business, except that the total of consignment sales will be credited to the personal account of the consignor, and not to Sales Account. For the amount of commission due to the consignee for sales effected by him, the entry is—

Debit Consignor's Personal Account.
Credit Commission Account.

The Consignor's Account may now be closed off in the usual manner, the settlement being effected by means of a draft or bill. If, at the end of the consignee's financial year, the consignor has not been paid in full, the balance due to or by consignor will appear in the Balance Sheet as a creditor or debtor, as the case may be. *Del credere* commission should be credited to a special account, and any Bad Debts incurred in respect of the particular consignment debited thereto. At the end of the accounting period, so much of the balance of the Commission Account as may be said to refer to completed transactions may be written off to Profit and Loss Account as a separate item.

Illustration. Taking the facts of the illustration on page 340 and assuming that the sales of the consignee, R. Rajah, were made in three items—

		£
19..		
Feb. 12.	Cash	400
	M. Madras (on credit) . .	700
	G. Ganges (on credit) . .	500

Show the accounts in the books of R. Rajah.

Dr. M. MADRAS *Cr.*

19..			£					
Feb. 12	To C. Cotton—Sales .		700					

Dr. G. GANGES *Cr.*

19..			£					
Feb. 12	To C. Cotton—Sales .		500					

Dr. BANK *Cr.*

19..			£	19..				£
Feb. 12	To C. Cotton—Sales .		400	Feb. 4	By C. Cotton—Expenses.			180

Dr. C. COTTON (CONSIGNOR) **Cr.**

		£			£
19.. Feb. 4	To Bank—Expenses	120	19.. Feb. 12	By Sales—	
12	„ Selling Commission	80		M. Madras . £700	
	„ *Del Cred.* Commission	20		G. Ganges . 500	
24	„ Bills Payable	1,380		Cash . . 400	1,600
		£1,600			£1,600

Dr. COMMISSION **Cr.**

					£
			19.. Feb. 12	By C. Cotton .	80

Dr. "DEL CREDERE" COMMISSION **Cr.**

					£
			19.. Feb. 12	By C. Cotton .	20

Dr. BILLS PAYABLE **Cr.**

					£
			19.. Feb. 24	By C. Cotton .	1,380

Assuming that G. GANGES defaulted, paying only 12 annas in the rupee[1] £125 would be credited to his account and debited to *Del Credere* Commission Account. The balance on this account (namely £105, debit balance) being a loss will be transferred to Profit and Loss Account, unless the consignee has in the past credited any balance on *Del Credere* Commission Account (after writing off Bad Debts) to a Reserve Account, in which case the £105 would be debited to that account.

Discounts and Allowances. Unless the terms of the contract specify otherwise, any discounts and allowances to debtors will be borne by the consignor, the consignee making the entry as follows—

Debit Consignor's Personal Account.
Credit Debtors.

Closing Stock. As the goods have not been purchased by the consignee, the Stock at the end must *not* be included in his final accounts, whether the first or the second method (explained below) be employed.

Second Method. The second method of dealing with consignments in the books of the consignee may be briefly tabulated as follows—

(*a*) Open a Consignment Inward Account, debiting that account with the invoice price of the goods; and crediting the Consignor's Personal Account.

(*b*) Debit the expenses paid by the consignee in respect of the consignment to Consignment Inward Account and credit cash or creditors.

(*c*) Debit Commission and *Del Credere* Commission on Sales to Consignment Inward Account and credit Commission Account and *Del Credere* Commission Account respectively.

[1] There are 16 annas to the rupee.

(*d*) Debit Cash or Debtors and credit Consignment Inward Account for Sales.

(*e*) The balance of Consignment Inward Account will be transferred to the Consignor's Personal Account.

(*f*) The payment to the consignor will be debited to his account and Bank (or Bills Payable) credited.

If the whole of the goods have not been sold by the consignee, the closing Stock will be entered in the books as follows—

(1) Credit Consignment Inward Account and bring down as a balance on the debit side.

(2) Debit Consignor's Personal Account and bring down as a balance on the credit side.

This method is rarely used.

Illustration. The entries (in respect of the transactions on pages 367 and 368) under this method will be—

Dr. CONSIGNMENT INWARD *Cr.*

19..			£	19..			£
Feb. 4	To Consignor—Goods		1,600	Feb. 12	By Sales (Cash or Debtors)		1,600
	,, Bank—Expenses		120	24	,, Balance—Stock	c/d	220
12	,, Commission Account		80				
	,, *Del Credere* Commission Account		20				
			£1,820				£1,820
Feb. 25	To Balance	b/d	220				

Dr. C. COTTON (CONSIGNOR) *Cr.*

19..			£	19..			£
Feb. 24	To Bills Payable Account		1,380	Feb. 4	By Consignment Inward Account		1,600
	,, Balance	c/d	220				
			£1,600				£1,600
				Feb. 25	By Balance	b/d	220

Dr. COMMISSION *Cr.*

				19..			£
				Feb. 12	By Consignment Inward Account		80

Dr. "DEL CREDERE" COMMISSION *Cr.*

				19..			£
				Feb. 12	By Consignment Inward Account		20

Advanced Problems

The following example is illustrative of the advanced type of problem. The working is explained fully where required, but it should be borne in mind that the principles to be applied are those already outlined.

Illustration. A, in London, consigns goods to B, in Australia, for sale at invoice price or over. B is entitled to a commission of 5 per

cent on invoice price and 25 per cent of any surplus price realized. A draws on B at 90 days' sight for 80 per cent of the invoice price, and, upon sale, B remits the balance of proceeds, after deducting his commission, by sight draft.

Goods consigned by A to B in the year 19.., cost A £10,450, including freight, and were invoiced at £14,200. Sales made by B were £13,380, and goods in his hands, unsold at 31st December, 19.., represented an invoice value of £3,460 (original cost £2,370, plus freight £240). Sight drafts actually received by A from B up to 31st December, 19.. were £3,140; others were in transit.

Prepare accounts in A's books of these transactions and show (by Ledger accounts) the manner in which the books would be closed at 31st December, 19...

Dr. CONSIGNMENT TO B *Cr.*

		Memo. £	£			Memo. £	£
19.. Dec. 31	To Goods (including Freight)	14,200	10,450	19.. Dec. 31	By Sales[1]	10,740	13,380
	,, B: Commission— 5% on £10,740		537		,, Stock (including Freight) c/d	3,460	2,610
	25% on £2,640		660				
	,, Profit and Loss Account		4,343				
		£14,200	£15,990			£14,200	£15,990
19.. Jan. 1	To Stock, etc. b/d	3,460	2,610				

Dr. B (CONSIGNEE) *Cr.*

			£				£
19.. Dec. 31	To Consignment to B Account— Sales		13,380	19.. Dec. 31	By Bills[2]		11,360
	,, Balance[3] c/d		2,768		,, Commission		1,197
					,, Bills[2]		3,140
					,, Bills in Transit		451
			£16,148				£16,148
				19.. Jan. 1	By Balance b/d		2,768

Dr. BILLS IN TRANSIT *Cr.*

			£				
19.. Dec. 31	To B (Consignee)		451				

Dr. GOODS ON CONSIGNMENT *Cr.*

		£	£			Invoice Price £	£
19.. Dec. 31	To Purchases (or Trading) Account	?		19.. Dec. 31	By Consignment to B	14,200	10,450
	,, Freight	?	10,450				

[1] This figure is the balancing item of the memorandum column.

[2] Posted to the debit of Bills Receivable Account.

[3] The Bills in transit may be calculated by writing up B's account and inserting the amount owing *to* him, viz., £2,768, which is 80% of the remaining stock of £3,460. The balance of the account represents Bills in transit.

Proof of B's Account. B, according to the agreement, is to account to A for the profit on the goods he sells, less commission.

The profit is—

	£	£
(1) Sales		13,380
(2) *Less* Invoice price of Goods consigned	14,200	
Less Invoice price of Goods on hand	3,460	
		10,740
∴ Profit		2,640

The commission thereon—

5% of £10,740 (Invoice price)	537	
25% of £2,640 (profit, as above)	660	
		1,197
Hence B owes for the difference		£1,443

When the goods were sent to B he paid A for four-fifths of the value of the WHOLE consignment of £14,200, his acceptance therefore being

$$\tfrac{4}{5} \times £14{,}200 = £11{,}360$$

Of the whole consignment, £10,740 has been sold by B so that, subject to his commission, he must account to A for the remaining one-fifth of the invoice price of the goods sold. It is clear that he has paid for four-fifths of the goods still unsold, but this is ignored for the present.

Consequently, B must account to A for $\tfrac{1}{5} \times$ £10,740, which is £2,148 added to the *net* profit of £1,443 as shown in the *above* statement. B is thus indebted to A for—

	£	£
(*a*) Net Profit	1,443	
(*b*) Balance of Invoice price of the Goods sold	2,148	
		3,591
Against which he has already remitted		3,140
Therefore Drafts in transit to clear are		£451

When B has received credit for his remittances and his commission, his account is clear so far as the Goods SOLD are concerned, but he has paid not only for the goods sold, but for four-fifths of the goods unsold, as he accepted a bill at the outset for four-fifths of the invoice price of the WHOLE consignment. Such unsold goods are—

	£
Invoice price of WHOLE Consignment	14,200
Less Invoice price of Goods sold	10,740
Remaining Goods	£3,460
B has paid for $\tfrac{4}{5}$ thereof =	£2,768

The latter figure is the amount standing to the credit of B's account.

The proof becomes simple if the student will imagine that two separate consignments were made, the first representing the goods sold, the second representing goods unsold.

Consignments	Invoice Price	Paid for by B	Unpaid for by B
	£	£	£
1st Consignment	10,740	8,592(*a*)	2,148(*b*)
2nd Consignment	3,460	2,768(*c*)	692(*d*)
Total . . .	£14,200	£11,360	£2,840

The Ledger Account in A's books will be—

Dr. B *Cr.*

	1st Consignment	2nd Consignment		1st Consignment	2nd Consignment
	£	£		£	£
To Sales . . .	13,380	*nil*	By Bill . .	8,592	2,768
„ Balance . c/d		2,768	„ Commission .	1,197	
			„ Bill . .	3,140	
			„ Bill in transit .	451	
	£13,380	£2,768		£13,380	£2,768
			By Balance . b/d		2,768

It can readily be understood that the first consignment is now completely disposed of; the proof of which is—

		£
1st Consignment—B owes for Sales		13,380
Less Amount paid by B when goods consigned (See *a*) .		8,592
		£4,788
or	£	£
Profit on Sale = Sales . .	13,380	
Less Invoice Price of Goods sold	10,740	
	2,640	
Plus Proportion of Cost still unpaid [$\frac{1}{5}$ × £10,740] (See *b*) .	2,148	
		£4,788
This is discharged by—		
(1) Commission due to B . .	1,197	
(2) Remittances . . .	3,591	
		£4,788

In order to make the problem complete, the second consignment will be dealt with; and for this purpose it is assumed that the remaining goods are sold for £4,460, the commission terms as before.

The account of B as to the second Consignment is continued from the balance brought down of £2,768.

Dr. **B (Second Consignment)** *Cr.*

							£
	To Sales		4,460		By Balance	b/d	2,768
					,, Commission		423
					,, Bills, etc.		1,269
			£4,460				£4,460

Proof—

		£	£
2nd Consignment—Sales			4,460
	Less Amount paid by B when Goods were consigned [$\frac{4}{5}$ × £3,460] (See *c*)		2,768
			£1,692
	or		
	Profit on Sale = Sales	4,460	
	Less Invoice Price of Goods sold	3,460	
		1,000	
	Plus Proportion of Cost still unpaid, [$\frac{1}{5}$ × £3,460] (See *d*)	692	
			£1,692
This is discharged by—		£	
	(1) Commission[1]	423	
	(2) Remittances	1,269	
			£1,692

The Consignment Account in A's books will be—

Dr. **Consignment to B** *Cr.*

			Invoice Price					Invoice Price	
			£	£				£	£
	To Balance[2]	b/d	3,460	2,610		By Sales (per Account Sales)		3,460	4,460
	,, Commission—5% on £3,460			173					
	25% on £1,000			250					
	,, Profit and Loss Account			1,427					
			£3,460	£4,460				£3,460	£4,460

The total profit will be—

	1st Consignment		2nd Consignment		Total	
	£	£	£	£	£	£
Sales		13,380		4,460		17,840
Less Cost	7,840		2,610		10,450	
Commission	1,197		423		1,620	
		9,037		3,033		12,070
Profit and Loss Account per Consignment Account		£4,343		£1,427		£5,770

[1] The Commission is calculated thus—

	£	
5% on £3,460	173	
25% on £4,460 − 3,460, i.e. on £1,000	250	
		£423

[2] See Consignment Account on page 370.

The following illustration is appended to demonstrate a joint venture completed on full double entry lines involving the principles applicable to Joint Venture and Consignment Accounts.

Illustration. A and B enter into a joint venture. A contributes £100 and B £150. They purchase for cash 20 Wireless Sets at £6 each, and consign 17 to their agent in Xland invoiced at $30 each. A pays freight of £10 4s. 0d. The agent pays landing charges of $189 on 15 only; the remaining 2, being irreparably damaged by water, are destroyed, a claim being preferred against the underwriters. The agent incurs selling costs of $89 and is entitled to 5 per cent commission on sales and a further 10 per cent commission on net profits *after* charging up *both* commissions.

The sales of the Xland agent are 5 at $58 each.

As to the remaining 10, 5 have been sent from Xland to Yland, and the Yland agent reports that he has sold them for $660 net, and remits to Xland a draft therefor.

Of the 3 remaining in England 2 are sold for cash for £8 each. In the meantime A and B have withdrawn respectively £40 and £60 from the Joint Cash Account. They share profits 1 : 2.

The Xland agent remits a draft for $250.

Rates of Exchange may be taken as—

Xland	$ 5 to £
Yland	$10 to £

The accounts in the joint venture books are shown below—

JOINT VENTURE BOOKS

Dr. A *Cr.*

			£	s.	d.				£	s.	d.
	To Cash . . .		40	0	0		By Cash		100	0	0
	,, Balance . .	c/d	74	4	0		,, Consignment to Xland Account —Expenses . .		10	4	0
							,, ⅓ Profit . .		4	0	0
			£114	4	0				£114	4	0
							By Balance . .	b/d	74	4	0

Dr. B *Cr.*

			£	s.	d.				£	s.	d.
	To Cash . . .		60	0	0		By Cash . . .		150	0	0
	,, Balance . .	c/d	98	0	0		,, ⅔ Profit . .		8	0	0
			£158	0	0				£158	0	0
							By Balance . .	b/d	98	0	0

Dr. **CASH** *Cr.*

			£	s.	d.			£	s.	d.
	To A and B		250	0	0	By Joint Venture Account		120	0	0
	" Xland Agent[1]		50	0	0	" A		40	0	0
	" Sales		16	0	0	" B		60	0	0
						" Balance	c/d	96	0	0
			£316	0	0			£316	0	0
	To Balance	b/d	96	0	0					

Dr. **UNDERWRITERS** *Cr.*

			£	s.	d.			£	s.	d.
	To Consignment to Xland Account		13	4	0					

TRIAL BALANCE

	Dr. £	s.	d.	Cr. £	s.	d.
A				74	4	0
B				98	0	0
Cash	96	0	0			
Underwriters	13	4	0			
Consignment to Xland	45	12	0			
Xland Agent	11	8	0			
Joint Venture Account (Stock)	6	0	0			
	£172	4	0	£172	4	0

Note. The gross sales of the Yland Agent (if given) would be credited to Consignment Account and the expenses debited to the same account—NOT the *net* realized Value AFTER expenses, unless the Yland Agent is the Agent of the Xland Agent, in which case the net proceeds will be credited to the latter and his commission based thereon. The entries are made in the Xland Consignment Account, as for practical purposes it is part of the latter consignment.

B's Books —

Dr. **A** *Cr.*

			£	s.	d.			£	s.	d.
	To Cash		150	0	0	By Cash		60	0	0
	" ⅓ Profit		8	0	0	" Balance	c/d	98	0	0
			£158	0	0			£158	0	0
	To Balance	b/d	98	0	0					

Note. This account corresponds to B's Account in the Joint Venture books.

A's Books—

Dr. **B** *Cr.*

			£	s.	d.			£	s.	d.
	To Cash		100	0	0	By Cash		40	0	0
	" Consignment Expenses		10	4	0	" Balance	c/d	74	4	0
	" ⅓ Profit		4	0	0					
			£114	4	0			£114	4	0
	To Balance	b/d	74	4	0					

Note. This account corresponds to A's Account in the Joint Venture books.

[1] Paid into cash for convenience.

Dr. GOODS ON CONSIGNMENT **Cr.**

	Units	$	£	s.	d.		Units	$	£	s.	d.
To Joint Venture Account . .	17	510	102	0	0	By Consignment to Xland Account	17	510	102	0	0

Dr. CONSIGNMENT TO XLAND **Cr.**

	Units	$	£	s.	d.		Units	$	£	s.	d.
To Goods on Consignment . .	17	510	102	0	0	By Underwriters .	2	66	13	4	0
,, A—Freight .		51	10	4	0	,, Sales . . .	10	620	124	0	0
,, Xland Agent—						,, Stock[2] . . c/d	5	228	45	12	0
Landing Charges		189	37	16	0						
Selling Expenses		89	17	16	0						
5% Sales Commission .		31	6	4	0						
,, Profit—											
Xland Agent[1] $\frac{1}{11}$		4		16	0						
Joint Venture Account . $\frac{9}{1?}$		40	8	0	0						
	17 $	914	£182	16	0		17 $	914	£182	16	0
To Stock . . b/d	5	228	45	12	0						

[1] i.e. $\frac{1}{11}$ of £8 16s.

[2] i.e. $\frac{5}{15}$ of £136 16s. made up as follows—

	£	s.	d.	$
Cost of 17 units	112	4	0	561
Less 2 covered by Insurance	13	4	0	66
Cost of 15 units	99	0	0	495
Add Landing Charges	37	16	0	189
	£130	16	0	$684

Dr. **Xland Agent** Cr.

	$	£	s.	d.		$	£	s.	d.
To Sales	290	58	0	0	By Consignment to Xland Account—				
,, ,,[1]	330	66	0	0	Landing Expenses .	189	37	16	0
					Selling Expenses . .	89	17	16	0
					Commission 5% of $620.	31	6	4	0
					$\frac{1}{10}$ Profits . . .	4		16	0
					,, Draft	250	50	0	0
					,, Balance . . c/d	57	11	8	0
$	620	£124	0	0	$	620	£124	0	0
To Balance . . b/d	57	11	8	0					

Dr. **Joint Venture Account** Cr.

	Units	£	s.	d.		Units	£	s.	d.
To Cash Purchase . .	20	120	0	0	By Goods on Consignment Account . . .	17	102	0	0
,, Profit— £ s. d.					,, Cash Sales	2	16	0	0
A, $\frac{1}{3}$. 4 0 0					,, Consignment to Xland Account—				
B, $\frac{2}{3}$. 8 0 0		12	0	0	Profit . . .		8	0	0
					,, Stock. . . c/d	1	6	0	0
	20	£132	0	0		20	£132	0	0
To Stock . . b/d	1	6	0	0					

[1] 660 Yland dollars equal 330 Xland dollars

CHAPTER XVIII

DEPARTMENTAL ACCOUNTS

ONE of the most important aims of accounting is the segregation and recording of activities, whether of buying or selling; of production, administration, or distribution. Departmental accounting aims at segregating the severable activities of a business in order to—

(i) Compare results.
(ii) Assist the proprietor in formulating policy.
(iii) Reward the departmental managers on results shown.

Departments may be classified according to functions, e.g. Buying, Selling, Production or Manufacturing, Subsidiary service, e.g. Transport, Packing, Repairs, and the like.

In most large businesses departmental accounts are employed, e.g. in the large general stores, whilst insurance companies are compelled by law to prepare separate accounts for Life, Marine, and Industrial branches. An Accountant may have Audit, Tax, Bankruptcy Departments, and so on.

It is usually not a matter of difficulty to ascertain the gross profit of each department, as the transactions may be easily analysed by means of columnar day books, of either the bound or the loose-leaf variety. So far as purchases are concerned there is, as a rule, one Ledger only to contain the accounts of the creditors, but if the departments *buy* from distinct and separate sources, a separate set of ledgers and day books may be employed. As regards sales, if customers buy from several departments it will be necessary to employ one Ledger (subdivided into areas or alphabetically, rather than departmentally), so that the whole of the transactions of the customer are contained under the one heading. The sales day books, bound or loose leaf, will be columnarized or, where necessary, a separate sales day book for each department employed. Returns Inwards and Outwards will be dealt with on the lines of Sales and Purchases, conversely treated.

Stock records will be employed where practicable, and at the end of each accounting period the stock will be ascertained for each department and compared with details disclosed by the stock records.

Where a concern occupies a warehouse, the whole of the purchases will first be passed through as purchases of the warehouse and charged out to departments, an amount usually being added to the cost to cover expenses of handling. Any stock not sent to the departments will be considered as warehouse stock.

Where other items are included in the Trading Account they are

normally of such a nature as to lend themselves to simple analysis, e.g. Wages and Carriage Inwards.

The general expenses chargeable against the gross profit will require allocation between the departments according to the actual circumstances; and even if a certain amount of latitude is allowed, in the absence of some rigid method of precise allocation, an attempt should be made to spread the expenses, because a department cannot be said to have earned a net profit until all the legitimate expenses of administration, selling, and distribution have been charged against its gross profit.

Allocation of Expenses. The methods of allocating expenses may be dealt with as follows—

(1) Expenses incurred *specifically* for the department will be charged direct thereto, e.g. Repairs to Motors in a Transport Department.

(2) Expenses for the benefit of *all* the departments and capable of precise allocation will be debited accordingly, e.g. lighting, according to separate meterage.

(3) Expenses for the benefit of *all* departments *not* capable of precise allocation will be treated as follows—

(i) *Selling Expenses.* These will be charged on a sales basis, either (*a*) value or (*b*) units or quantities sold, e.g. Discounts allowed, Bad Debts, Selling Commissions, although occasionally some of these expenses may come under one of the other headings as in the case of bad debts, where separate Sales Ledgers are used for each department.

(ii) *Administration Charges.* Many charges, like Rent and Rates, may be apportioned to give approximately true results on the basis of (*a*) area, (*b*) windows used, (*c*) cubic content, (*d*) average stock held or sold. With regard to the apportionment of Rent and Rates, it is usual to charge a basic rate for each floor, the higher the storey the lower the proportion, and subdivide the amount into departments on the above lines, unless the department occupies one whole storey. For example, if three floors are used the ratios might be—

1st floor . . 3 2nd floor . 2 3rd floor . 1

Heating and Lighting (in absence of separate meters) may be apportioned on the basis of points wired, lamps used, area, or inversely to the number of windows.

Power, where not separately metered, is best apportioned on the basis of probable usage as determined by numbers and types of machines, adjusted where necessary according to running hours.

Many expenses may be apportioned exactly or approximately by examining the precise nature and function of the expenditure, e.g. advertising, insurance. Advertising may produce enormous

sales to one department and not to another, but that is no valid reason for allocating the cost on the basis of results produced—as is done in the case of selling commission—because the advertising expenditure will have been incurred even if no sales are effected, and may, in respect of a particular department, have proved abortive because of the relative inefficiency of that department. Although apportionment of the advertising expenses is usually made on the basis of sales, an approximation based upon advertising space occupied may be preferable. An electric sign advertisement will probably benefit all departments (unless one department is particularly singled out) and the cost should be apportioned equally to all departments for whose benefit the sign is utilized.

Insurance premiums may relate to stock, premises, loss of profits or workmen's compensation, and should be apportioned on the basis of stocks carried, proportion of premises occupied, profits earned in the preceding year, and wages respectively, unless some abnormal feature exists, e.g. extraordinary risk by reason of the nature of the goods—oil; or in the case of workmen's compensation, an abnormal degree of risk of accident to workmen and employees of one department as contrasted with another.

Depreciation will usually be allocable on the basis of assets employed in each department. (Depreciation of boilers will normally be included in the heating charge, depreciation of lorries in the transport charge, etc.)

(4) Where expenses are incurred for which *no basis of apportionment is practicable*, it is usual to bring down the departmental balance of profits and apportion these expenses equally against it so that the management will not be misled by the arbitrary nature of the apportionments, and at the same time will be able to ascertain the approximate net profit of each department.

In some concerns an apportionment of these expenses is made according to one of the following bases: (*a*) units sold, (*b*) floor space occupied, (*c*) assessment or valuation of space occupied, (*d*) average value of stock held by the particular department, (*e*) wages paid. Where bonuses and further remuneration are dependent upon net departmental results, some apportionment is required, but it is submitted that where no real basis exists, it is preferable to make such apportionments on an equal basis.

Where the concern is in receipt of non-departmental profits, e.g. dividends, the income should be added to the net profit of the departments equally, following the same principle.

Alternatively, the balance of departmental profits subject to any non-allocable expenses may be brought down in one total, and such expenses be debited and non-departmental profits credited without any attempt at apportionment.

(5) A charge (which does not represent an actual item of expenditure) is often made for *Interest* based upon the estimated amount of average capital employed by each department. This entry does

not affect the total net profit, since it is an internal adjustment only, viz. a debit to each department and a total credit to Profit and Loss Account. Similarly, a "notional" rent charge is often made to departments which occupy premises owned by the firm.

Inter-departmental Transfers. Where goods, or the employment of staff or performance of services are exchanged as between departments, they should be separately recorded and shown as separate items in the departmental columns of the Trading and Profit and Loss Account. The transfers will be either at cost or at loaded price, care being taken in the latter case to eliminate from the total results the unrealized profit. Such profit is not realized by the concern as a WHOLE until the goods have been disposed of to outside purchasers. (The treatment of unrealized profit in departments is considered in Chapter XXXII.)

Illustration. A. Ltd., Hotel Proprietors, have incurred, *inter alia*, expenditure as follows—

	Rooms	*Meals*	
	£	£	
Chambermaids	473	211	(= £684)
Kitchen Staff . . .	521	317	(= £838)
	£994	£528	

Show how these items are dealt with in the Departmental Profit and Loss Account.

		£	£
Apartments . . .	*Dr.*	684	
Restaurant . . .	*Dr.*	838	
To Apartments .			994
,, Restaurant .			528
		£1,522	£1,522

Illustration. Code & Dray Ltd. are in business as coal retailers and carriers. They transport the coal they purchase from the railway siding and deliver it in their own vehicles.

For a certain period the wages of their transport staff, debited to Transport Department, are £1,695, of which £173 are attributable to transport of coal to their depot, £408 to delivery of coal to customers and staff, and £1,114 to transport work for customers.

The depot consumes coal estimated at £35, depot expenses being appportionable 3/7 to Coal and 4/7 to Transport. The staff are supplied with coal free, estimated at £120 and wages connected therewith £24. The quantities of coal delivered to the staff are roughly in proportion to their respective wages, exclusive of those incurred in delivery to the staff.

Show how the above would appear in the Departmental Profit and Loss Account, assuming that no outside transport expenses are incurred.

Dr. DEPARTMENTAL PROFIT AND LOSS ACCOUNT (includes) *Cr.*

	Coal	Transport		Coal	Transport
	£	£		£	
To Wages		(b) 1,695			
„ Transfers—					
Wages in Transport of Coal to Depot	(a) 173		By Transfer		(b) 173
Wages *re* Delivery to Customers	(a) 384		„ Transfer (£408 — 24)		(b) 384
Coal Consumed at Depot	15	20	„ Transfer	35	
Coal Supplied to Staff	(x) 40	(x) 80	„ Transfer	120	
Wages *re* Staff Coal	(x) 8	(x) 16	„ Transfer (£408 — 384)		(b) 24

(*x*) Wages in (*a*) Coal £173 + £384 = £557.

(*b*) Transport £1,695 — £173 — £384 — £24 = £1,114.

∴ Proportion is 1 : 2.

The following examples are typical, and illustrative of the principles explained.

Illustration. From the following Trial Balance prepare Departmental Trading and Profit and Loss Account for the year ended 31st December, 19.., and Balance Sheet at that date.

TRIAL BALANCE
AS AT 31ST DECEMBER, 19..

		Dr.	*Cr.*
		£	£
Stock at 1st January, 19..—	A Dept.	1,700	
	B „	1,450	
Purchases—	A „	3,540	
	B „	3,020	
Sales—	A „		6,080
	B „		5,125
Wages—	A „	820	
	B „	270	
Rent, Rates, Taxes, and Insurance		939	
Sundry Expenses		360	
Salaries		300	
Lighting and Heating		210	
Discounts Allowed		222	
Discounts Received			65
Advertising		368	
Carriage Inwards		234	
Furniture and Fittings		300	
Plant and Machinery		2,100	
Sundry Debtors		606	
Sundry Creditors			1,860
A—Capital			4,766
A—Drawings		450	
Cash at Bank		990	
Cash in hand		17	
		£17,896	£17,896

The following information is also provided—

(1) Internal transfer of goods from A Department to B Department, £42.

(2) The items: Rent, Rates, Taxes, and Insurance; Sundry Expenses; Lighting and Heating; Salaries; and Carriage Inwards to be apportioned—⅔ A Dept., ⅓ B Dept.

(3) Advertising to be apportioned equally.

(4) Discounts allowed and received are apportioned on the basis of Departmental Sales and Purchases (excluding transfers).

(5) Depreciation at 10 per cent per annum on Furniture and Fittings and on Plant and Machinery to be charged ¾ to A Dept., ¼ to B Dept.

(6) Services rendered by B Dept. to A Dept. included in Wages, £50.

(7) The Stock at 31st December, 19..: A Dept., £1,674; B Dept., £1,205.

(8) There have been no additions to or Sales of Plant or Furniture.

DEPARTMENTAL TRADING AND PROFIT AND LOSS ACCOUNT

Dr. FOR THE YEAR ENDED 31ST DECEMBER, 19.. *Cr.*

	A Dept.	B Dept.	Total		A Dept.	B Dept.	Total
	£	£	£		£	£	£
To Stock	1,700	1,450	3,150	By Sales	6,080	5,125	11,205
„ Purchases	3,540	3,020	6,560	„ *Departmental Transfers*	*42*	*50*	
„ Carriage Inwards	156	78	234	„ Stock	1,674	1,205	2,879
„ Wages	820	270	1,090				
„ *Goods*		*42*					
„ *Wages*	*50*						
„ Gross Profit c/d	1,530	1,520	3,050				
	£7,796	£6,380	£14,084		£7,796	£6,380	£14,084
To Salaries	200	100	300	By Gross Profit b/d	1,530	1,520	3,050
„ Rent, Rates, Taxes, and Insurance	626	313	939	„ Discounts Received (*b*)	35	30	65
„ Lighting and Heating	140	70	210	„ Loss	126		
„ Sundry Expenses	240	120	360				
„ Advertising	184	184	368				
„ Discounts Allowed (*a*)	121	101	222				
„ Depreciation	180	60	240				
„ Profit [1]		602	476				
	£1,691	£1,550	£3,115		£1,691	£1,550	£3,115

(*a*) Ratio of Sales, 6,080 : 5,125; (*b*) ratio of Purchases, 3,540 : 3,020.

[1] The total net profit of £476 is arrived at thus—

		£
B Dept.	Net Profit	602
A Dept.	Net Loss	126
	Balance	£476

Balance Sheet as at 31st December, 19..

	£	£		£	£
Capital at 1st Jan., 19..	4,766		Fixed Assets—		
Add Profit for year	476		Plant and Machinery at 1st Jan., 19..	2,100	
	5,242		*Less* Depreciation at 10% per annum	210	
Less Drawings	450				1,890
		4,792	Furniture and Fittings at 1st Jan., 19..	300	
Current Liabilities—			*Less* Depreciation at 10% per annum	30	
Sundry Creditors		1,860			270
					2,160
			Current Assets—		
			Stock	2,879	
			Sundry Debtors	606	
			Cash at Bank	990	
			Cash in hand	17	
					4,492
		£6,652			£6,652

Illustration. Carr was the proprietor of a garage, the following Trial Balance being extracted from his books on 31st Dec., 19...

Trial Balance as at 31st December, 19..

	Dr. £	Cr. £
Capital		3,300
Drawings	400	
Opening Stocks—		
Tools	150	
Petrol and Oil	56	
Spare Parts and Tyres	295	
Private Cars (including Repair Van £210)	4,770	
Purchases—		
Tools	176	
Spare Parts and Tyres	212	
Petrol and Oil	625	
Advertising	104	
Rent, Rates and Lighting	680	
Insurance—		
Hire Cars	125	
Fire, Burglary, etc.	20	
Wages—		
Chauffeurs	1,650	
Repair Department	706	
Office	250	
Garage	450	
Sales—		
Petrol and Oil		532
Spare Parts and Tyres		346
Receipts—		
Hiring		4,326
Repairs		1,542
Garaging		950
Carried forward	£10,669	£10,996

TRIAL BALANCE AS AT 31ST DECEMBER, 19..—(*Contd*)

	Dr	Cr.
	£	£
Brought Forward	10,669	10,996
Licences for Hire Cars	145	
Office Expenses	296	
Sundry Debtors	95	
Sundry Creditors		164
Commission on Cars Sold		340
Cash at Bank	295	
	£11,500	£11,500

The following additional information was extracted—

(*a*) The stocks on hand, 31st December, 19.., were valued at—

Tools	£106
Petrol and Oil	42
Spare Parts and Tyres	164

(*b*) Petrol valued £340 and oil £62 were used by the Hire Department during the year; petrol, valued at £28 and oil at £14 were used by the Repairs Department; private consumption amounted to £16.

(*c*) Repairs Department performed work on private cars valued at £234. In addition, £40 work was performed on the proprietor's own car.

(*d*) Spare parts used by Repairs Department during the year were valued at £322.

(*e*) Depreciation of Private Hire Cars and Repair Van at 20 per cent per annum.

(*f*) Rent, Rates and Lighting to be apportioned as follows—

Repair Dept.	$\frac{1}{4}$	Garage	$\frac{1}{2}$
Hire Dept.	$\frac{1}{8}$	Office.	$\frac{1}{8}$

(*g*) The licence £10, and insurance £10, for the proprietor's own car are included in the insurance and licences paid by the business.

You are required to prepare Departmental Trading Account and Profit and Loss Account for the year ended 31st December, 19.., and a Balance Sheet at that date.

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 19..

Dr.				Cr.
	£		£	£
To Wages (Office)	250	By Balance, being Gross Profit— b/d		
,, Rent, Rates and Lighting	85	Petrol and Oil	353	
,, Advertising	104	Spare Parts and Tyres	325	
,, Office Expenses	296	Repairs	314	
,, Insurance	20	Hire	793	
,, Net Profit transferred to Capital Account	1,530	Garage	160	
				1,945
		,, Commission on Cars		340
	£2,285			£2,285

Departmental Trading Account
for the Year ended 31st December, 19..

Dr.

	Petrol and Oil	Spare Parts, etc.	Repair Dept.	Hire Dept.	Garage
	£	£	£	£	£
To Stock	56	295	150		
" Purchases[1]	625	212	176		
" Wages			706	1,650	450
" Licences[2]				[1] 145	
" Rent, Rates and Lighting			170	85	340
" Depreciation on Private Cars				912	
" Depreciation on Repair Van			42		
" Insurance on Cars[2]				[1] 125	
" Spare Parts and Tyres (b)			322		
" Petrol and Oil (a)			42	402	
" Repairs (c)				234	
" Balance, being Gross Profit c/d	353	325	314	793	160
	£1,034	£832	£1,922	£4,346	£950

Cr.

	Petrol and Oil	Spare Parts, etc.	Repair Dept.	Hire Dept.	Garage
	£	£	£	£	£
By Sales	532	346			
" Receipts			1,542	4,326	950
" Department Transfers	(a) 444	(b) 322	(c) 234		
" Stock	42	164	106		
" Drawings—					
Licence[1] . £10					
Insurance[1] . 10				20	
Repairs			40		
Petrol and Oil[1]	16				
	£1,034	£832	£1,922	£4,346	£950

[1] The transfers for Drawings are shown separately for sake of clarity. Actually they would be credited to the respective accounts, leaving a net charge to the Trading Account, e.g. Licences in Hire Department would be £135 net; Insurance, £115 net; Petrol and Oil Purchases, £609 net.

[2] No amounts are given for insurance and licence on Repair Van.

BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£	£		£	£
Capital—			Fixed Assets—		
Balance 1st Jan., 19..	3,300		Private Hire Cars	4,560	
Add Profit for Year	1,530		*Less* Depreciation	912	
					3,648
	4,830		Repair Van	210	
Less Drawings[1]	476		*Less* Depreciation	42	
		4,354			168
			Current Assets—		
			Stock—		
			Petrol and Oil	42	
			Spare Parts and		
Current Liabilities—			Tyres	164	
Sundry Creditors		164	Tools	106	
					312
			Sundry Debtors		95
			Cash		295
		£4,518			£4,518

Illustration. Jones Bros., wholesale stores, purchase goods as follows—

A Dept. 500 articles
B Dept. 1,000 articles } Total cost £10,000
C Dept. 1,200 articles

Commencing stocks were—

A Dept. 60 articles B Dept. 40 articles C Dept. 76 articles

Their sales were—

A Dept. 510 articles at 80s. each
B Dept. 960 articles at 90s. each
C Dept. 1,248 articles at 100s. each

Assuming the percentage rate of gross profit is the same in the case of all three articles, prepare Departmental Trading Account showing the gross profit on trading to be carried to the firm's Profit and Loss Account. Stocks to be valued on the same basis as purchases.

As the rates of gross profit are the same for each type of article,

[1] The proprietor's Drawings Account is made up as follows—

	£
Cash	400
Petrol and Oil	16
Repairs	40
Insurance	10
Licence	10
	£476

the cost price of the goods sold must be in the ratio 8 : 9 : 10, so that the total cost £10,000 must be divided thus—

					£	s.	d.	
500 × 8 =	4,000 =	$\frac{4}{25}$ × £10,000 =	£1,600 =		3	4	0	per article
1,000 × 9 =	9,000 =	$\frac{9}{25}$ × £10,000 =	£3,600 =		3	12	0	per article
1,200 × 10 =	12,000 =	$\frac{12}{25}$ × £10,000 =	£4,800 =		4	0	0	per article
	25,000							

Profit per article—

	Sale price £ s. d.		Cost price £ s. d.	
A Dept.	4 0 0	less	3 4 0	= 16s.
B Dept.	4 10 0	,,	3 12 0	= 18s.
C Dept.	5 0 0	,,	4 0 0	= £1

The numbers of different articles sold are—

	A	B	C
Opening Stock	60	40	76
Purchases	500	1,000	1,200
	560	1,040	1,276
Closing Stock	50	80	28
Sales	510	960	1,248

The profit must therefore be—

		£
A Dept.	510 × 16s. =	408
B Dept.	960 × 18s =	864
C Dept	1,248 × £1 =	1,248
	[as below]	£2,520

The Departmental Trading Account may now be prepared:—

DEPARTMENTAL TRADING ACCOUNT FOR THE YEAR ENDED .

Dr. *Cr.*

	A	B	C	Total		A	B	C	Total
	£	£	£	£		£	£	£	£
To Stock[1] . .	192	144	304	640	By Sales[2] . .	2,040	4,320	6,240	12,600
,, Purchases .	1,600	3,600	4,800	10,000	,, Stock . .	160	288	112	560
,, Gross Profit .	408	864	1,248	2,520					
	£2,200	£4,608	£6,352	£13,160		£2,200	£4,608	£6,352	£13,160

The opening and closing stocks are valued on the same basis as purchases, e.g.—

Opening Stock of A Dept. 60 × £3 4s. = £192
Closing ,, ,, 50 × £3 4s. = £160

[1] Columns may be inserted for quantities.
[2] A Dept. Sales are 510 articles at £4 each = £2,040

Alternatively, the cost price and gross profit per article may be calculated—

Total Sale price of articles purchased—

		£
A	500 × £4	2,000
B	1,000 × £4 10s.	4,500
C	1,200 × £5	6,000
		12,500
Total Cost price		10,000
Gross Profit		£2,500

This shows a rate of gross profit of 20% on Sales, therefore—

Cost price of A	80s. — 16s. = 64s.
B	90s. — 18s. = 72s.
C	100s. — 20s. = 80s.

Illustration. A commenced business on 1st January, 19.., with—

	£
Stock—	
A Dept.	300
B Dept.	500
Fixtures	400
Cash	600

The transactions are—

	£
Purchases—A Dept.	3,100
B Dept.	2,900
Receipts from Debtors	5,200
Discounts Allowed to Debtors	200
Payments to Creditors	4,720
Cash Sales—A Dept.	380
B Dept.	920
Credit Sales—A Dept.	3,700
B Dept.	2,900
General Expenses—A Dept.	300
B Dept.	420
Unallocated expenses	480
Drawings	400
Cash in hand	580
Selling Expenses	200
Cartons, etc., purchased	320
Creditors outstanding	1,600
Stock on hand at 31st December, 19..—A Dept.	420
B Dept	580
Cartons on hand at 31st December, 19..	110

Unallocated general expenses are to be apportioned on the basis of floor space occupied, which is in the ratio of 5 : 3.

Selling expenses are to be apportioned on the basis of cartons sold, viz., A 60,000, B 45,000.

Prepare: (1) Trial Balance.
(2) Departmental Trading and Profit and Loss Account.
(3) Balance Sheet as at 31st December, 19...

It will be necessary to open and write up the following accounts before preparing the Trial Balance and accounts—

Dr. CASH Cr.

			£				£
19..				19..			
Jan. 1	**To Sundries**		800	Dec. 31	By Creditors—		
Dec. 31	,, Cash Sales—				Cash Paid		4,720
	A Dept.		380		,, Expenses—		
	B Dept.		920		A Dept.		300
	,, Debtors—				B Dept.		420
	Cash Received		5,200		Unallocated		480
					,, Selling Expenses		200
					,, Drawings		400
					,, Balance	c/d	580
			£7,100				£7,100
19..							
Jan. 1	To Balance	b/d	580				

Dr. FIXTURES Cr.

			£				
19..							
Jan. 1	**To Sundries**		400				

Dr. SUNDRY CREDITORS Cr.

			£				£
19..				19..			
Dec. 31	To Cash		4,720	Dec. 31	By Purchases[1]—		
	,, Balances	c/d	1,600		A Dept.		3,100
					B Dept.		2,900
					,, Cartons		320
			£6,320				£6,320
				19..			
				Jan. 1	By Balances	b/d	1,600

Dr. STOCK Cr.

		A £	B £				
19..							
Jan. 1	**To Sundries**	300	500				

Dr. GENERAL EXPENSES Cr.

		A £	B £				
19..							
Dec. 31	To Cash	300	420				

Dr. CAPITAL Cr.

							£
				19..			
				Jan. 1	**By Sundries**		1,800

Dr. GENERAL EXPENSES (*unallocated*) Cr.

			£				
19..							
Dec. 31	To Cash		480				

Dr. SUNDRY DEBTORS Cr.

			£				£
19..				19..			
Dec. 31	To Sales—A Dept.		3,700	Dec. 31	By Cash		5,200
	,, ,, B Dept.		2,900		,, Discounts		200
					,, Balances	c/d	1,200
			£6,600				£6,600
19..							
Jan. 1	To Balances	b/d	1,200				

Dr. DISCOUNTS ALLOWED Cr.

			£				
19..							
Dec. 31	To Debtors		200				

[1] Direct to Trial Balance.

Dr SALES Cr.

				19..			A	B
							£	£
				Dec. 31	By Cash		580	920
					,, Debtors		3,700	2,900

Heavy type denotes opening entries, posted from the Journal.

TRIAL BALANCE AS AT 31ST DECEMBER, 19..

	Dr.	Cr.
	£	£
Cash in hand	580	
Capital		1,800
[1]Drawings	400	
Creditors		1,600
[2]Purchases—Goods: A Dept.	3,100	
B Dept.	2,900	
Cartons	320	
Sales—A Dept.		4,080
B Dept.		3,820
Debtors	1,200	
Discount	200	
[1]Selling Expenses	200	
General Expenses—A Dept.	300	
B Dept.	420	
Unallocated	480	
Fixtures	400	
Stock—1st January, 19 : A Dept	300	
B Dept.	500	
	£11,300	£11,300

DEPARTMENTAL TRADING AND PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 19..

Dr. Cr.

	A Dept.	B Dept.	Total		A Dept.	B Dept.	Total
	£	£	£		£	£	£
To Stock	300	500	800	By Sales	4,080	3,820	7,900
,, Purchases—Goods	3,100	2,900	6,000	,, Stock	420	580	1,000
Cartons (1)	120	90	210				
,, Gross Profit c/d	980	910	1,890				
	£4,500	£4,400	£8,900		£4,500	£4,400	£8,900
To General Expenses (2)	600	600	1,200	By Gross Profit b/d	980	910	1,890
,, Selling Expenses (3)	115	85	200				
,, Discounts Allowed (4)	114	86	200				
,, Net Profit transferred to Capital Account	151	139	290				
	£980	£910	£1,890		£980	£910	£1,890

BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£	£		£	£
Capital—			Fixed Assets—		
Balance 1st Jan, 19..	1,800		Fixtures		400
Add Profit for year to date	290		Current Assets—		
	2,090		Stock—Goods	1,000	
Less Drawings	400		Cartons	110	
		1,690	Sundry Debtors	1,200	
Current Liabilities—			Cash	580	
Sundry Creditors		1,600			2,890
		£3,290			£3,290

[1] Direct from Cash Book.
[2] Direct from Ledger Account (Creditors).

(1) Cartons are apportioned in the ratio of 60,000 : 45,000, or as 4 : 3.

	£
Cartons as per Trial Balance	320
Less Stock as per Balance Sheet . . .	110
	£210

(2) General Expenses apportionment—

	A Dept.	B Dept.
	£	£
(*a*) As per Trial Balance	300	420
(*b*) Unallocated General Expenses (Ratio 5 : 3) .	300	180
	£600	£600

(3) and (4). Selling Expenses and Discounts are apportioned in the same ratio as the cartons, viz. 4 : 3.

General Illustration. From the following details, prepare tabular Trading and Profit and Loss Account, showing (i) percentage of gross profit to sales; (ii) percentage of net profit to sales; (iii) expenses per £ of sales—

Departments	A	B	C
	£	£	£
Stocks (opening)	2,000	1,300	1,000
Purchases	7,000	4,200	3,630
Sales	8,127	5,418	4,515
Stocks (closing)	3,073	1,332	1,165

	£
Expenses :	
Rent, Rates, and Insurance	2,100
General	840

Apportion rent, rates, and insurance equally to departments.
Apportion general expenses in relation to sales of each department.

The following observations on this illustration should be particularly noted—

(1) Apart from the completion of the total column and *one* departmental column, the question is merely one of detail, involving no question of principle.

(2) Hence, until other questions have been dealt with in the examination, the candidate should content himself by completing the total column and a "sample" column.

(3) The same principle should be adopted in regard to the arithmetic part, although in many cases the figures presented to the candidate are often simple, e.g. in the above illustration the sales ratios are 9 : 6 : 5.

(4) The General Expenses item would usually be presented in several detailed subdivisions.

TRADING AND PROFIT AND LOSS ACCOUNT FOR THE

	Dept. A	Dept. B	Dept. C	Total
	£	£	£	£
Sales	8,127	5,418	4,515	18,060
Cost of Sales—				
Opening Stock	2,000	1,300	1,000	4,300
Purchases	7,000	4,200	3,630	14,830
	9,000	5,500	4,630	19,130
Less Closing Stock . . .	3,073	1,332	1,165	5,570
	5,927	4,168	3,465	13,560
Gross Profit	2,200	1,250	1,050	4,500
	£8,127	£5,418	£4,515	£18,060
Percentage of Gross Profit to Sales .	*27·07%*	*23·07%*	*23·26%*	*24·92%*
Administrative Expenses—				
Rent, Rates and Insurance . .	700	700	700	2,100
General	378	252	210	840
	1,078	952	910	2,940
Net Profit	1,122	298	140	1,560
	£2,200	£1,250	£1,050	£4,500
Percentage of Net Profit to Sales . .	*13·80%*	*5·50%*	*3·10%*	*8·64%*
Expenses per £ of Sales . . .	*2s. 8d.*	*3s. 6d*	*4s. 0½d.*	*3s. 3d.*

Illustration. The Directors of Dockets Ltd. wish to ascertain approximately the separate net profits of three particular departments, viz. A, B, and C, for the three months ended 31st March, 19. . .

It is not practicable to take stock on that date, but the accounting system is adequate and the rates of gross profit (calculated without reference to direct expenses) are stable at 40 per cent, 30 per cent, and 15 per cent on Sales of the three departments respectively.

Indirect expenses are to be charged in proportion to departmental sales, except as to one-sixth, which is to be divided equally.

The following figures are extracted from the books—

		A	B	C
		£	£	£
Stock, 1st January, 19.		3,000	2,800	4,100
Sales	for the three	14,000	12,000	20,000
Purchases	months ended	9,000	7,200	16,400
Direct Expenses	31st March, 19. .	1,830	2,840	2,300

Indirect Expenses covering all five departments were £3,600. The Sales of the other departments were £14,000.

Prepare a statement showing estimated net profits of the three departments for the three months to 31st March, 19. ., making a Stock Reserve for each department (due to special temporary conditions) of 5 per cent on the estimated value at 31st March, 19. . .

DOCKETS LIMITED

Statement of Estimated Profit for the Three Months ended 31st March, 19..

	Departments					
		A		B		C
	£	£	£	£	£	£
Stock, 1st January, 19..		3,000		2,800		4,100
Purchases . . .		9,000		7,200		16,400
		12,000		10,000		20,500
Less Sales . . .	14,000		12,000		20,000	
Less Gross Profit .	(40%) 5,600	8,400	(30%) 3,600	8,400	(15%) 3,000	17,000
Estimated Stock, 31/3/19.		£ 3,600		£ 1,600		£ 3,500
Estimated Gross Profit .		5,600		3,600		3,000
Less Stock Reserve (5%)	180		80		175	
Direct Expenses .	1,830		2,840		2,300	
Indirect Expenses:						
On Sales . .	700		600		1,000	
Equally . .	120		120		120	
		2,830		3,640		3,595
	Profit	£ 2,770	Loss	£ 40	Loss	£ 595

Notes: (1) It is assumed that there is no Stock Reserve at the beginning of the period.

(2) Indirect Expenses are calculated as follows—

		Sales Proportion		Equally
		£		£
Indirect Expenses—Total £3,600	$\frac{5}{6}$	3,000	$\frac{1}{6}$	600
Less attributable to other departments. . .	$\frac{14,000}{60,000} \times$ £3,000	700	$\frac{2}{5} \times$ £600	240
		£2,300		£360
Proportion: A	$\frac{14}{60} \times$ £3,000	700	$\frac{1}{5} \times$ £600	120
B	$\frac{12}{60} \times$ £3,000	600	,,	120
C	$\frac{20}{60} \times$ £3,000	1,000	,,	120
		£2,300		£360

Alternatively, as the expenses to be apportioned on a sales basis are £3,000 and the total sales are £60,000, the percentage is 5 per cent of the respective sales, e.g. A, 5 per cent of £14,000 = £700, etc.

(3) The total Trading Account of the three departments is—

	£		£
To Stock.	9,900	By Sales	46,000
,, Purchases . . .	32,600	,, Stock (estimated) .	8,700
,, Gross Profit c/d . .	12,200		
	£54,700		£54,700
To Stock Reserve . .	435	By Gross Profit b/d . .	12,200
,, Direct Expenses . .	6,970		
,, Indirect Expenses .	2,660		
,, Net Profit . . .	2,135[1]		
	£12,200		£12,200

[1] A, Profit £2,770, *less* B and C, Losses £40 and £595.

CHAPTER XIX

BRANCH ACCOUNTS

BRANCH Accounts have for their purpose the recording of the transactions of branches, whether they relate to dealings with the head office, with outsiders, or to dealings between different branches of the same concern. No hard-and-fast rule can be laid down as defining the distinction between a branch and a department; in fact, in many instances a system of accounting suitable for dealing with departmental activities will be entirely adequate for branches. As a general statement, it may be said that where a section of a business is segregated physically from the main section it is a branch; in other words, if the location of activities is separated from the main place of operation, there may be said to be a head office and a branch.

In spite of this statement, it should be borne in mind that in cirucmstances where complete control is exercised over the activities of a subsidiary section, the management may, and often does, consider it in the light of a mere department.

The methods of accounting applicable to dealings and transactions of and with branches are legion, so that what is the most practical and efficient method applicable to any particular case can only be determined in the light of the particular circumstances of the concern. The branch may be a small retail shop run by a single employee, selling only goods sent by the head office; or, taking the other extreme, it may be a foreign branch situate thousands of miles from the head office, buying its own materials, and manufacturing and distributing the products in its own area—whose activities can only be controlled in a very small degree by the head office.

Thus location, the degree of control exercised by the head office, the nature of the activities and the goods dealt in, the character and status of the personnel, and the number of the branches will all be determining factors in considering what system of accounting is to be adopted.

In many instances mere academic theory must be sacrificed for the sake of expediency and practical results, but whatever treatment is adopted, it should, so far as possible, furnish the head office readily and reliably with the means of arriving at the financial results (in such detail as may be required) and with a check on the efficiency and integrity of the staff of each branch, as well as details as to the comparative efficiency of each branch.

Main Divisions. The main divisions of branch accounting are consequential upon the question of whether full accounting records are, or are not, kept at the branch.

The two main divisions are—

I. Where the accounting of the branch is performed at the head office.

II. Where the branch performs the accounting functions for itself.

It will be necessary to outline the different systems briefly, and each will then be duly considered and illustrated.

As to (I) the system adopted may be—

(a) **Departmental Method.** (See Chapter XVIII.)

(b) **Debtors System,** where all the goods are supplied and the expenses paid by the head office. This merely involves debiting the branch with opening debtors (if any), goods, and expenses, and crediting it with its sales, returns to head office, closing stock, and the closing debtors (if any). Where the assets of the branch are to be recorded distinct from the head office assets, separate Branch Asset Accounts will be opened in the head office books.

If small local purchases are made by the branch, and petty cash disbursements permitted, the same principle will apply, except that the branch must furnish details of these purchases; or, if they are paid for out of receipts, furnish, in addition, a detailed summary of its Cash Account. As to petty cash payments, a detailed summary will have to be furnished to head office. These payments, both as to local purchases and as to petty cash, may be financed on the Imprest System, but this merely obviates any incursion into actual receipts, as the latter will be banked intact locally, daily or at suitable intervals, as required.

(c) **The " Stock and Debtors " System.** By this method a Branch Stock Account, and (where credit sales are made) a Branch Debtors Account, are kept for the branch quite distinct from the Branch Expenses Account. The Branch Stock Account will be debited with the goods received, credited with returns to head office, sales, and the closing stock brought down in the ordinary way. The treatment of the Stock Account will vary according to the method employed of charging the goods out to the branch. The three most common methods are—

(α) At cost price.

(β) At selling price.

(γ) At cost price to which a certain percentage (loading) is added. This system involves the keeping at the head office of two, or (if credit sales are made) three accounts in respect of the branch, i.e. (1) Branch Stock Account, (2) Branch Expenses Account, and (3) Branch Debtors Account. If local purchases and petty cash disbursements are permitted, similar treatment to that in *(b)* will be accorded thereto, except that goods purchased locally must be recorded separately from goods obtained from head office. As a rule, the selling price and cost price plus loading methods are not adopted where considerable local purchases are permitted, because such methods are employed for the purpose of enabling a simple

check to be kept on stock, and the presence of locally bought goods will tend to render such a check more complicated.

(II) Where the branch performs its own book-keeping, the characteristic features are that in the first place in the head office books the branch is debited with the initial outlay, and with goods sent (if any) and credited with remittances and returns; at the same time, the branch will maintain in its books a Head Office Account which will be reciprocal to the Branch Account in the head office books. Secondly, the branch profit or loss will be ascertained from the branch results compiled from the double entry book-keeping at the branch, and the Branch Account in the head office books will be adjusted (as will be shown) from such results. Thus, in branches of type (I) the profit or loss is ascertained from the Branch Accounts in the head office books, whereas as regards those of type (II) the profit or loss is obtained from the accounts kept by the branch, and the result subsequently incorporated in the head office books.

No difference in principle exists as regards foreign branches, but its application is complicated by the necessity for converting inter-branch transactions, remittances, and the Branch Profit and Loss Account and Balance Sheet compiled in foreign currency into sterling.

Miscellaneous Points. Before proceeding to illustrate the methods outlined it will be convenient here to deal with a few general matters with reference to Branch Accounts.

(1) The head office may be purely a "clearing house," i.e. it may be responsible for the buying on behalf of ALL the branches, and its function may extend no further. On the other hand, side by side with such a function, it may carry on its own business and sell goods in the ordinary way.

(2) Where the branches are dispersed over a wide area, the head office may perform functions as in (1), except that it delegates to special branches the work of intensive distribution, i.e. of distributing goods within certain circumscribed areas, e.g. a multiple concern with branches in every large town might have its head office and chief distributing centre in London with distributing branches (*a*) in Manchester for Lancashire, Yorkshire, Derbyshire, etc.; (*b*) in Bristol for the West Country, and (*c*) in Birmingham for the Midlands. A special feature (affecting detail but not principle) arises here in that the costs of distributing and handling the goods is a cost, the burden of which should be allocated equitably as between all the branches.

(3) Sales may be expressed (in the absence of abnormal features) not as *sales*, but as *cash received plus discounts plus closing debtors, less opening debtors*, and this roundabout presentation in place of an ordinary straightforward statement tends to create difficulties for students. In dealing with Branch Accounts this matter is important, particularly as the item "cash received" is sometimes split into (*a*) "cash sales" and (*b*) "cash received from debtors." If, however, it is perceived that in both cases the receipt simply relates

to *cash*, and that the other elements mentioned above are given (or are ascertainable), no difficulty should be encountered in determining the amount of sales by the process of building up the Branch Debtors Account.

(4) Although no precise dividing line can be laid down, it is most usual for wholesale branches (or head office where all orders are executed by it) to be treated departmentally and for retail branches to be treated in one or other of the methods of branch accounting, more often, perhaps, with the main records at the head office.

This procedure will be adopted where the branch merely acts as agent, the actual execution of transactions being performed by the head office, the only difference being that there will be no goods physically supplied to the branch, but a transfer will have to be made to the debit of Branch Profit and Loss Account for the cost of such goods as if they had actually been sent to the branch instead of being consigned elsewhere on its behalf. Any profit or loss will be transferred from the Branch Profit and Loss Account to the Head Office Profit and Loss Account. In *all* cases, provision should be made for bringing Stock on hand down, if necessary, to market value; but where there are loaded values (see page 410) the adjustment should be made by means of Stock Reserve or Provision, leaving the loaded price and cost price undisturbed.

The principles will now be illustrated.

DEBTORS SYSTEM

Illustration. Entries in head office books—

Dr. X BRANCH *Cr*

19..			£	19..				£
Jan. 1	To Sundry Assets	(*a*)	100	Dec. 31	By Cash		(*d*)	200
Dec. 31	„ Goods from H.O.	(*b*)	580		„ Returns		(*e*)	22
	„ Expenses (paid by Branch)	(*c*)	30		„ Stock	£50		
	„ Expenses (paid by H.O.)		7		„ Debtors	500		
	„ Profit and Loss Account		155		„ Sundry Assets	100	c/d	650
			£872					£872
19..								
Jan. 1	To Balances	b/d	650					

As regards the items on the debit side, the double entry will be completed by credits as follows: (*a*) to Cash, Creditors or Sundry Assets Accounts, (*b*) to Purchases Account, and (*c*) to Cash representing the reimbursement to the branch by the Head Office in respect of petty cash expenses: the double entry for the items on the credit side will be completed by debits as follows: (*d*) to Cash Account, (*e*) to Purchases Account.

The two deficiencies of the above method are that no checks are provided on stock and debtors. These deficiencies may be counteracted by an efficient system of control of stock and debtors,

the latter being usually capable of more accurate check than the former.

In this illustration a *pro forma* Debtors Account by way of *memorandum* may be built up as follows—

Dr. SUNDRY DEBTORS *Cr.*

		£			£
To Opening Balances	b/d	Nil	By Cash		200
" Sales		700	" Closing Balances	c/d	500
		£700			£700
To Balances	b/d	500			

It can be seen that, assuming that moneys received by the branch are banked without retention of any part at all, the actual sales figure is the total of the cash received and closing debtors (there being no opening debtors).

It should further be noted that the branch may not pay into the bank intact all moneys received from debtors, or in respect of cash sales; or, even if it does, there may be a lapse of a few days in so doing. In the latter case, it will be necessary to take such lapse of time into account in arriving at the sales figure.

Not infrequently the branch assets are segregated and shown in separate accounts, in which case the sundry assets items of £100 will not appear in this account at all, but in the Branch Assets Account.

The Debtors System, as will be seen, may be supplemented by a memorandum Trading Account. The information is furnished by the branch in its weekly or other periodic returns. Where there are numerous branches a total account may be compiled by means of summary sheets.

It is not unusual for examiners to present summarized data as supplied from the branches (in fact, a copy of the information as it appears in the branch books), from which the head office accounts are to be compiled.

The principles may be best explained by means of a simple example.

Illustration.[1] The following is a summary of the accounts as supplied by the branches—

Dr. (M) BRANCHES CASH *Cr.*

		£			£
To Balance	b/d	100	By Head Office		2,350
" Cash Sales.	(*A*)	400	" Balance	c/d	70
" Receipts from Debtors	(*B*)	1,920			
		£2,420			£2,420
To Balance	b/d	70			

[1] Elementary students of Branch Accounts should defer the study of this with the succeeding illustration until the whole chapter has been read.

Dr. (M) BRANCHES DEBTORS *Cr.*

			£				£
	To Balances	b/d	300		By Cash	(B)	1,920
	,, Sales	(C)	1,960		,, Discounts	(D)	50
					,, Returns	(E)	60
					,, Balances	c/d	230
			£2,260				£2,260
	To Balances	b/d	230				

The following is the account of the branches in the head office books—

Dr. BRANCHES *Cr.*

			£				£
	To Balance—				By Cash		2,350
	Cash . £100				,, Balance—		
	Debtors . 300				Cash . £70		
	Stock . 200	b/d	600		Debtors . 230		
	,, Goods		2,000		Stock . 240	c/d	540
	,, Profit to Profit and Loss Account		290				
			£2,890				£2,890
	To Balance	b/d	540				

Prepare Memorandum Branches Final Accounts.

The first two accounts marked (M) are merely memorandum serving to supply details necessary to analyse the amount of profit.

It will be seen from the Branches Account that they are accountable for the opening balance of £600 plus goods received £2,000, less cash remitted £2,350. This amounts to £250, but as the assets at the end are £540 there must be a profit of £290.

The amount of £290 is now to be proved.

This figure may be proved by building up the "Double Entry," on the assumption that the information contained in the Memorandum Accounts is to be converted into full double entry—

Memorandum

Dr. BRANCHES TRADING AND PROFIT AND LOSS ACCOUNT *Cr.*

			£				£
	To Stock		200		By Cash Sales (A) . £400		
	,, Purchases		2,000		,, Credit Sales (C) 1,960		
	,, Discounts (D)		50				2,360
	,, Sales Returns (E)		60		,, Stock	B.S.	240
	,, Net Profit		290				
			£2,600				£2,600

BRANCHES BALANCE SHEET

	£		£
Head Office (Ledger)	540	Cash (Ledger)	70
		Debtors (Ledger)	230
		Stock (Profit and Loss)	240
	£540		£540

The branch books would, if built up on double entry lines, contain the following accounts—

Dr. HEAD OFFICE[1] *Cr.*

			£				£
	To Cash.	(g)	2,350		By Balance .	b/d	600
	" Balance	c/d	540		[i.e. Stock (o) £200 Cash. (o) 100 Debtors (o) 300]		
					" Goods	(c)	2,000
					" Profit and Loss Account	(f)	290
			£2,890				£2,890
					By Balance .	b/d	540

Dr. CASH *Cr.*

			£				£
	To Balance . . b/d	(o)	100		By Cash remitted to H.O.	(g)	2,350
	" Cash Sales	(a)	400		" Balance .	c/d	70
	" Debtors		1,920				
			£2,420				£2,420
	To Balance	b/d	70				

Dr. DEBTORS *Cr.*

			£				£
	To Balances . . b/d	(o)	300		By Cash		1,920
	" Sales	(b)	1,960		" Discounts	(d)	50
					" Returns .	(e)	60
					" Balances.	c/d	230
			£2,260				£2,260
	To Balances .	b/d	230				

The following rules should be carried out—

(1) All the items on the debit and credit sides of the Branch Accounts must be accounted for on the SAME side in the Memorandum Accounts.

(2) All the remaining items in the Memorandum Accounts must contain double entry amongst themselves.

The items in the Branch Accounts will now be considered in detail—

		£	MEMO figures
(1) Balances Debit	Cash .	100	DEBIT of Cash Account
	Debtors	300	Debtors
	Stock	200	Trading Account
(2) Goods Debit	. .	2,000	DEBIT of Trading Account
(3) Profit Debit	. .	290	DEBIT of Profit and Loss Account
(4) Cash Credit	. .	2,350	CREDIT of Cash Account
(5) Balances Credit	Cash.	70	CREDIT of Cash Account
	Debtors	230	Debtors
	Stock	240	Trading Account

[1] This account is exactly reverse to the Branches Account in the head office books, and consequently in preparing the accounts the vital account is the Head Office Account as it would appear in the books of the Branches. This account, together with the above information, would supply the usual Double Entry, but as the Branches Account as it appears in the head office books is given instead of the Head Office Account as it would appear in the books of the Branches, the compilation must be adjusted accordingly.

All these are in heavy type in the preceding example.

It will now be seen that the remaining items in the Memorandum Accounts have double entry, viz.—

(*A*)	Cash Sales	Debit Cash	Credit Trading Account
(*B*)	Receipts from Debtors	,, ,,	,, Debtors
(*C*)	(Credit) Sales	,, Debtors	,, Trading Account
(*D*)	Discounts	,, Profit and Loss Account	,, Debtors
(*E*)	Returns	,, Trading Account	,, ,,

It may be observed that if a Head Office Account in the books of the branches were opened it would be the same on the *reverse side* as the Branches Account in the head office books; so that if the Branches Account in the head office books be viewed as if it were the reciprocal account in the branch books, the double entry aspect is simple enough.

Lest any confusion arises it must be stated that the only double entry that appears in the head office books is comprised by the postings to and from Branches Account; **the Memorandum Accounts being merely supplementary information to that shown in the Branches Account in the head office books.**

Illustration. The head office supplies its branches with goods at cost price, and pays all expenses other than petty cash of the branches. Weekly returns are furnished to the head office, the summaries of which are as follows—

Dr. BRANCHES CASH *Cr.*

			£				£
To Balances	b/d	(1)	200	By Petty Cash		(c)	270
,, Receipts from Debtors		(*a*)	15 000	,, Bank		(2)	19,730
,, Cash Sales		(*b*)	5 000	,, Balances	c/d	(8)	200
			£20,200				£20,200
To Balances	b/d	(8)	200				

Dr. BRANCHES DEBTORS *Cr.*

			£				£
To Balances	b/d	(3)	1,200	By Cash		(*a*)	15,000
,, Sales		(*e*)	18,600	,, Discounts		(*f*)	420
				,, Bad Debts		(*f*)	580
				,, Balances	c/d	(8)	3,800
			£19,800				£19,800
To Balances	b/d	(8)	3,800				

HEAD OFFICE books—

Dr. BRANCHES *Cr.*

				£					£
To Balance—					By Expenses		b/d	(6)	350
Cash .	(1) £200				,, Bank .		.	(2)	19,730
Debtors	(3) 1,200				,, Balance.		c/d	(h)	2,920
Sundry Assets	(9) 2,000								
Stock.	(4) 3,000	b/d		6,400					
,, Goods .			(5)	16,000					
,, Expenses			(6)	500					
,, Sundry Assets purchased			(10)	100					
				£23,000					£23,000
To Balance.		b/d	(h)	2,920	By Balance—				
,, Expenses		c/d	(11)	150	Cash	£200		(6)	
,, Profit and Loss Account			(12)	5,080	Debtors	3,800			
					Sundry Assets	2,050			
					Stock	2,100	c/d		8,150
				£8,150					£8,150
To Balance		b/d	(8)	8,150	By Expenses		b/d	(11)	150

Closing stock, £2,100. Expenses outstanding, £150. Write off £50 depreciation on sundry assets.

Prepare Memorandum Trading and Profit and Loss Account.

Dr. *Memorandum* TRADING AND PROFIT AND LOSS *Cr.*

			£					£
To Stock .		(4)	3,000	By Sales—				
,, Purchases		(5)	16,000	Cash	£5,000		(b)	
,, Gross Profit	c/d	(d)	6,700	Credit	18,600		(e)	23,600
				,, Stock .		.	(8)	2,100
			£25,700					£25,700
To Sundry Expenses		(7)	300	By Gross Profit .		b/d	(d)	6,700
,, Petty Cash		(c)	270					
,, Discounts		(f)	420					
,, Bad Debts			590					
,, Depreciation .		(i)	50					
,, Net Profit		(12)	5,080					
			£6,700					£6,700

Dr. *Memorandum* SUNDRY ASSETS *Cr.*

			£				£
To Balances	b/d	(9)	2,000	By Profit and Loss Account	.	(i)	50
,, Cash Purchase	.	(10)	100	,, Balances.	c/d	(8)	2,050
			£2,100				£2,100
To Balances	b/d	(8)	2,050				

Dr *Memorandum* SUNDRY EXPENSES *Cr*

			£				£
To Cash .		(6)	500	By Expenses o/s	b/d	(6)	350
" Expenses o/s	c/d	(10)	150	" Profit and Loss Account .		(J)	300
			£650				£650
				By Expenses o/s .	b/d	(11)	150

Items numbered are "same side" items.

Items lettered are "double entry" items.

As has been indicated, if the Branches Account in the head office books were written up in the Branch Accounts on the reverse side, the four accounts, viz.—

(1) Branches Cash;
(2) Branches Debtors;
(3) Head Office Account;
(4) Trading and Profit and Loss Account,

would provide the complete double entry; therefore in compiling the Memorandum Trading and Profit and Loss Account, the items in Branches Account in the head office books are to be accounted for on the SAME side

If account (3) were actually in the branches, it would appear—

Dr HEAD OFFICE *Cr*

		£			£
To Balance .	c/d	8,000	By Balance	b/d	2,920
			" Profit and Loss Account		5,080
		£8,000			£8,000
			By Balance	b/d	8,000

This account is reverse to the Branches Account in the head office books The Branch Balance Sheet would be—

BRANCH BALANCE SHEET

	£		£	£
Expenses Outstanding	150	Cash		200
Head Office	8,000	Debtors		3,800
		Sundry Assets	2,100	
		Less Depreciation	50	
				2,050
		Stock		2,100
	£8,150			£8,150

Illustration. Retailers Co have three retail branches. The branches pay in the cash received each day to head office and are supplied with goods from head office, wages and all expenses being paid by cheque from head office. The branches keep their own Sales Ledgers and make weekly returns of trade done and cash received.

From the following details extracted from the branch weekly returns and head office books, prepare—

(*a*) Three separate Branch Accounts as they will appear in the head office books, showing profit or loss on each branch for the six months to 31st December.

(*b*) Memorandum Trading and Profit and Loss Account proving the figures disclosed by (*a*).

	K	L	M
	£	£	£
Book Debts, 1st July	2,800	2,500	950
Stock, 1st July	2,000	1,900	1,800
Credit Sales for six months	10,000	11,000	7,500
Sales Returns	75	80	95
Ready Money Sales	4,500	7,000	2,500
Ledger Accounts—Cash	9,400	10,000	7,200
Bad Debts	120	90	5
Goods received from Head Office	9,000	11,500	8,000
Wages and Expenses	2,400	4,000	1,900
Rent and Rates	450	850	400
Book Debts, 31st December	3,205	3,330	1,150
Stock, 31st December	2,500	1,600	2,100

It will be observed that in the Branch Accounts (page 406) appear book debts (commencing and ending) and cash remitted, whilst in the Memorandum Trading and Profit and Loss Account are substituted Sales, less Returns and Bad Debts. These two sets of figures should agree, thus in Branch K—

Dr *Memorandum* DEBTORS *Cr.*

		£			£
To Balances	b/d	2,800	By Returns	(*b*)	75
,, Sales	(*b*)	10,000	,, Bad Debts		120
			,, Cash	(*a*)	9,400
			,, Balances	c/d	3,205
		£12,800			£12,800
To Balances	b/d	3,205			

(*a*) The Cash remitted is £9,400, plus Ready Money Sales £4,500 = £13,900

(*b*) Total net sales, including Ready Money Sales £4,500, are as follows—

		£
(1) Cash Sales		4,500
(2) Credit Sales	£10,000	
Less Returns	75	
		9,925
		£14,425

Reference should be made to item (*b*) in the memorandum Trading and Profit and Loss Account (Branch K) as shown on page 406.

Alternatively, the reconciliation might be rendered easier by charging up the ready money sales to debtors and including the receipts therefrom in the Debtors Account (dealing with Branch K) as under—

Dr. *Memorandum* DEBTORS *Cr*

		£			£
To Balances	b/d	2,800	By Returns		75
,, Sales		14,500	,, Bad Debts		120
			,, Cash		13,900
			,, Balances	c/d	3,205
		£17,300			£17,300
To Balances	b/d	3,205			

Dr. **Branches** *Cr.*

		K	L	M			K	L	M
19..		£	£	£	19..		£	£	£
July 1	To Balances . b/d (Book Debts and Stock) . .	4,800	4,100	2,750	Dec 31	By Cash . . (*a*)	13,900	17,000	9,700
						,, Balances . c/d (Book Debts and Stock)	5,705	4,930	3,250
Dec 31	,, Goods . .	9,000	11,500	8,000		,, Net Loss . .			100
	,, Wages and Exps .	2,400	4,000	1,900					
	,, Rent and Rates	450	850	400					
	,, Net Profit .	2,955	1,180						
		£19,605	£21,930	£13,050			£19,605	£21,930	£13,050
	To Balances . b/d	5,705	4,930	3,250					

Dr. *Memorandum* Trading and Profit and Loss Account for the Six Months ended 31st December, 19 *Cr.*

		K	L	M			K	L	M
19..		£	£	£	19..		£	£	£
July 1	To Stock . . .	2,000	1,900	1,800	Dec 31	By Sales, less Returns . (*b*)	14,425	17,920	9,905
Dec 31	,, Purchases . .	9,000	11,500	8,000		,, Stock . . .	2,500	1,600	2,100
	,, Gross Profit . c/d	5,925	6,120	2,205					
		£16,925	£19,520	£12,005			£16,925	£19,520	£12,005
	To Wages and Exps .	2,400	4,000	1,900		By Gross Profit . b/d	5,925	6,120	2,205
	,, Rent and Rates .	450	850	400		,, Net Loss . .			100
	,, Bad Debts . .	120	90	5					
	,, Net Profit . .	2,955	1,180						
		£5,925	£6,120	£2,305			£5,925	£6,120	£2,305

"STOCK AND DEBTORS" SYSTEM

(*a*) **Where the goods are invoiced at cost.**

Illustration. From the facts contained in the illustration on page 398, the following accounts will appear in the head office books.

Dr. BRANCH STOCK *Cr.*

19 .			£	19 .			£
Dec. 31	To Goods (Purchases Account) . .		580	Dec. 31	By Sales . . .		700
	,, Gross Profit to Branch Profit and Loss Account . .		192		,, Returns (Purchases Account) . .		22
					,, Balance . . .	c/d	50
			£772				£772
19 Jan. 1	To Balance . . .	b/d	50				

Dr. BRANCH DEBTORS *Cr.*

19 .			£	19.			£
Dec. 31	To Sales . . .		700	Dec. 31	By Cash . . .		200
					,, Balances. . .	c/d	500
			£700				£700
19 Jan. 1	To Balances . . .	b/d	500				

Dr. BRANCH EXPENSES *Cr.*

19 .			£	19 .			£
Dec. 31	To Head Office Cash .		30	Dec. 31	By Branch Profit and Loss Account .		37
	,, ,, ,, ,, .		7				
			£37				£37

Dr. SUNDRY ASSETS *Cr.*

19 .			£				
Jan. 1	To Balances . .	b/d	100				

Dr. BRANCH PROFIT AND LOSS ACCOUNT *Cr.*

19 .			£	19 .			£
Dec. 31	To Expenses . . .		37	Dec. 31	By Gross Profit from Branch Stock Account . .		192
	,, Net Profit to General Profit and Loss Account . .		155				
			£192				£192

It has been assumed that there are no discounts allowed to debtors or bad debts, and that all receipts from debtors are immediately banked.

In the Stock and Debtors System, Discounts and Allowances will be dealt with in the usual way, i.e. debit Discounts Allowed and Allowances, credit Branch Debtors.

Illustration. The following are the details of a new branch.

	£
Goods sent to Branch at Cost	500
Goods returned from Branch at Cost . . .	30
Expenses Paid by Head Office	100
Remittances from Branch	420
Receipts from Debtors not paid in by Branch . .	30
Cash Sales	25
Credit Sales	520
Branch Stock—closing	170
Branch Debtors—closing	77
Discounts Allowed to Customers by Branch . .	18

Show accounts both under the Debtors System and under the Stock and Debtors System.

(1) In the Debtors System, the following account will appear in the head office books—

Dr. BRANCH *Cr.*

		£				£
To Goods from H.O. .		500	By Returns . .			30
,, Expenses . .		100	,, Remittances to H O .			420
,, Profit to General Profit and Loss Account .		127	,, Cash .	£30		
			,, Stock . .	170		
			,, Debtors . .	77	c/d	277
		£727				£727
To Balance . . .	b/d	277				

Proof of Debtors—

Dr. *Memorandum* DEBTORS *Cr*

		£			£
To Sales . .		520	By Cash		425
			,, Discounts . .		18
			,, Balance . . .	c/d	77
		£520			£520
To Balance	b/d	77			

The cash received must be—

		£
Cash Sales		25
Receipts from Debtors . .		425
		£450
Accounted for by—		
Remittances . . .	£420	
Balance in hand . .	30	
		£450

The sales are made up as follows—

	£
Cash received from Debtors .	425
Discounts	18
Closing Debtors. . .	77
	520
Less Opening Debtors . .	nil
	£520

(2) In the Stock and Debtors System the accounts in the books of the head office would be—

Dr BRANCH STOCK *Cr.*

		£			£
To Goods . . .		500	By Returns . .		30
,, Gross Profit to Branch Profit and Loss Account . .		245	,, Cash Sales . .		25
			,, Credit Sales . .		520
			,, Balance . . .	c/d	170
		£745			£745
To Balance . . .	b/d	170			

Dr BRANCH EXPENSES *Cr*

		£			£
To Expenses . .		100	By Branch Profit and Loss Account		118
,, Discounts . .		18			
		£118			£118

Dr BRANCH DEBTORS *Cr.*

		£			£
To Sales . .		520	By Cash . .		425
			,, Discounts .		18
			,, Balance .	c/d	77
		£520			£520
To Balance . . .	b/d	77			

Dr BRANCH CASH *Cr*

		£			£
To Branch Debtors .		425	By Remittances to H.O.		420
,, Cash Sales. .		25	,, Balance . .	c/d	30
		£450			£450
To Balance . .	b/d	30			

Dr. BRANCH PROFIT AND LOSS ACCOUNT *Cr.*

		£			£
To Expenses (detailed) .		118	By Gross Profit from Branch Stock Account		245
,, Net Profit to General Profit and Loss Account . .		127			
		£245			£245

(β) Where Goods are Invoiced at Selling or Loaded Price.

The second manner of dealing with the Stock and Debtors method is to invoice goods to the branch at loaded prices, either at selling price, or at a price which represents cost plus a percentage.

Where the goods sent from head office are invoiced to the branch at selling price, the cash remitted and retained, plus the closing stock, should equal the total of the opening stock and the goods invoiced, less returns. An efficient check may thus be kept on the branch manager.

The suitability of this method must depend on circumstances, the chief of which are—

(1) Type and size of the business;

(2) Stability of prices, buying and selling, quantities and qualities, particular regard being paid to storage facilities;

(3) The number of different classes of goods handled;

(4) The degree of variability in gross profit rates, particularly where goods purchased cannot be returned, e.g. newspapers;

(5) Whether price reductions are required or usual through end of season sales, change in fashions, perishable goods, etc.

The advantages of the method are—

(1) Efficient check on stock and receipts from sales, especially where goods are sold at absolutely fixed prices;

(2) Even where many lines are dealt in, the method will be helpful as a check, although not so close as in (1);

(3) As the stock (at selling price) is known at any time, interim accounts can be prepared without the need for approximating stock;

(4) The Branch Manager need not be informed of the cost price.

The disadvantages are—

(1) The need for pricing out all lines at both cost and selling price, although many large firms do not attempt a strictly accurate result and price out by sampling only;

(2) The method is useless where goods are perishable or deteriorate quickly, or where selling prices are not fixed or wide discretion as to prices is given to Branch Managers.

The selling price method is adopted where the goods are sold at certain fixed prices, e.g. proprietary articles, whereas the "percentage on cost" method is adopted where the selling price cannot be rigidly determined beforehand, or where the goods are of a mixed type, e.g. costumiers, greengrocers, and butchers. Where the loaded price method is adopted, the books kept by the branch will be memorandum, the essential double entry book-keeping being done by the head office. Three accounts will be kept in the head office books—

(1) Branch Stock Account.

(2) Goods sent to Branches Account.

(3) Branch Adjustment Account.

The Branch Stock Account deals with all goods received, returned, and sold by the branch, whereas the Branch Adjustment Account

is in effect a Branch Trading Account. These accounts seem to cause students a considerable amount of difficulty, but if their functions are thoroughly understood no difficulties should arise.

When goods are sent to the branch, Branch Stock Account is debited with the full invoice price of the goods, the cost price being credited to a Goods Sent to Branches Account and the loading (i.e. the difference between the cost price and the invoice price) credited to the Branch Adjustment Account, it being in effect the anticipated profit that will be made by the branch on the sale of these goods. The converse entries will be made for returns by the branch to the head office. Alternatively, the goods may be credited at the invoice price to the Goods Sent to Branches Account and returns from branch to head office debited thereto at full invoice price, the net loading being transferred in one sum to the Branch Adjustment Account at periodic intervals.

Illustration. A, Ltd., sends to its Oxford branch goods costing £150. They are invoiced at selling price, £200, being $33\frac{1}{3}$ per cent on *cost*. Goods £40 are returned to head office. The entries showing the record of these transactions in the head office books are—

		£	£
Oxford Branch Stock	*Dr.*	200	
Goods sent to Branches	*Cr.*		150
Oxford Branch Adjustment	*Cr.*		50
Goods sent to Branches	*Dr.*	30	
Oxford Branch Adjustment	*Dr.*	10	
Oxford Branch Stock	*Cr.*		40

Or alternatively—

Oxford Branch Stock	*Dr.*	200	
Goods sent to Branches	*Cr.*		200
Goods sent to Branches	*Dr.*	40	
Oxford Branch Stock	*Cr.*		40
Goods sent to Branches	*Dr.*	40	
Oxford Branch Adjustment	*Cr.*		40

It will be seen that in each case the credit balances are £120 on Goods Sent to Branches Account and £40 on Oxford Branch Adjustment Account, being cost price of goods sent (less returns), £120 and loading of £40. The latter is $33\frac{1}{3}$ per cent of £120, or 25 per cent of £160.

At the end of the accounting period, Goods Sent to Branches Account will be closed off by a transfer to Purchases Account in order that the Head Office Trading Account may show the true figure in respect of head office purchases.

The branch will periodically send details of sales effected to the head office accompanied by the cash in respect of such sales. From the information supplied, the head office will debit cash for cash received in respect of sales, debit Branch Debtors Account in respect of credit sales (if any), and credit Branch Stock Account with the total sales.

At the end of the accounting period, the balance of Branch Stock Account will be brought down to the debit of that account. This figure represents the amount of stock at *loaded* price held by the branch. This figure must be reduced to cost for the purposes of determining the profit, and this result is achieved by debiting the Branch Adjustment Account above the line and crediting it below the line with the amount of the loading on the closing stock, this being the *unrealized* profit on the stock. In the Balance Sheet the balances of the Branch Stock Account and of the Branch Adjustment Account will be offset, the result being shown as Stock at Branches at cost. The balance on the Branch Adjustment Account will now represent the gross profit made by the branch during the period, and be transferred to Branch Profit and Loss Account.

Illustration. B, Ltd., has a branch at Bristol. The firm deals in one standard article, the gross profit on which is 25 per cent on cost price. All goods are invoiced to the branch at selling price. All sales are for cash. The branch transactions for the year to 31st December, 19.., are—

	£
Goods from Head Office at Invoiced Price	6,000
Goods returned to Head Office at Invoiced Price	100
Cash Sales	4,900
Stock on hand at 31st Dec., 19.., at Invoiced Price	1,000

All cash is remitted to the head office weekly. The Bristol Branch Stock Account, the Bristol Branch Adjustment Account, and the Goods Sent to Branch Account will appear in the head office books as follows—

Dr. BRISTOL BRANCH STOCK *Cr.*

			£				£
19.. Dec. 31	To Goods		6,000	19.. Dec. 31	By Returns		100
					,, Sales—Cash		4,900
					,, Balance	c/d	1,000
			£6,000				£6,000
19.. Jan. 1	To Balance	b/d	1,000				

Dr. BRISTOL BRANCH ADJUSTMENT ACCOUNT *Cr.*

			£				£
19.. Dec. 31	To Branch Stock Account 20% on £100		20	19.. Dec. 31	By Branch Stock Account— 20% on £6,000		1,200
	,, Gross Profit transferred to Branch Profit and Loss Account		980				
	,, Balance— 20% on £1,000	c/d	200				
			£1,200				£1,200
				19.. Jan. 1	By Balance	b/d	200

Dr. GOODS SENT TO BRANCH *Cr.*

			£				£
19.. Dec. 31	To Branch Stock Account —Returns . .		80	19. Dec. 31	By Bristol Branch Stock		4,800
	„ Transfer to Head Office Purchases Account .		4,720				
			£4,800				£4,800

In the Balance Sheet the stock at branch will be shown at cost, i.e. £1,000 – £200 = £800. It must be remembered that if goods are loaded at 25 per cent on cost price, it is necessary to deduct 20 per cent from the loaded figure, i.e. selling price, to find the cost price. In questions of this type, students must exercise great care in the conversion to cost or selling price. If the question states the loading in terms of the cost price, it can easily be converted into a percentage on selling price, as in the above illustration. In loading up from cost to selling price (i.e. to find the amount to charge up to the branch) the increase must be in terms of *cost* price, whereas in "loading down" (i.e. to obtain the internal profit to transfer to Branch Adjustment Account) the decrease must be in terms of *selling* price.

In the above illustration the gross profit shown on the Branch Adjustment Account can be proved from the fact that the sales of the branch are £4,900. The rate of gross profit on sales is 20 per cent; therefore, the gross profit is £980.

Branch Expenses. It will usually be found in cases of this type that the branch will be allowed to make certain small payments on its own account. These may be dealt with in two ways—

(1) On the imprest system, cash being sent each week to the branch in respect of the past week's expenses.

(2) By allowing the branch to deduct the expenses from the cash received. In such cases it will be necessary to open a Branch Cash Account, to which all cash sales will be debited, the credit for which will appear in the Branch Stock Account. All expenses paid by the branch must be credited to this account and debited to a Branch Expenses Account. Finally, the cash remitted will be credited to the Branch Cash Account. If no money is retained, the Branch Cash Account will balance; should any cash be retained, it will be equal to the debit balance on the account.

Illustration. Cash sales by branch are £2,000, of which £200 has been utilized in payment of expenses and £1,780 remitted. The Branch Cash Account will appear in the Head Office books as follows—

Dr. BRANCH CASH *Cr.*

			£				£
	To Sales— Branch Stock Account		2,000		By Expenses— Branch Expenses Account . .		200
					„ Head Office Account		1,780
					„ Balance . . .	c/d	20
			£2,000				£2,000
	To Balance . . .	b/d	20				

Where the branch makes, in addition to cash sales, a number of credit sales, the branch will usually keep Memorandum Sales Ledgers. In the head office books, the total of the credit sales will be credited to Branch Stock Account and debited to Branch Debtors Account. Converse entries are required for returns to Branch by its customers. The cash received from each branch must be split into two portions, that relating to cash sales being posted to the credit of Branch Stock Account and that relating to credit sales to the credit of Branch Debtors Account. Thus the balance on the Branch Debtors Account should always equal the total of the individual balances shown on the accounts in the Memorandum Ledger kept at the branch, subject to adjustment for bad debts, discounts, and allowances.

Illustration. A opens a new branch at Brighton to which all goods are invoiced at selling price, the gross profit being 25 per cent on sales. For the year to 31st December, 19.., the branch has the following transactions—

	£
Goods from Head Office (cost price) .	6,300
Goods returned to Head Office (invoice price)	800
Cash Sales	4,000
Credit Sales	2,000
Cash received from Debtors	1,600
Cash remitted to Head Office by Branch	5,300
Expenses paid by Branch	300

The accounts in the head office books will be as follows—

Dr. BRIGHTON BRANCH STOCK *Cr.*

19.. Dec. 31	To Goods sent to Branches Account[1] . .		£ 8,400	19.. Dec. 31	By Returns . . .		£ 800
					,, Cash Sales . .		4,000
					,, Credit Sales . .		2,000
					,, Balance . . .	c/d	1,600
			£8,400				£8,400
19.. Jan. 1	To Balance . . .	b/d	1,600				

Dr. BRIGHTON BRANCH ADJUSTMENT ACCOUNT *Cr.*

19.. Dec. 31	To Transfer to Branch Profit and Loss Account— Gross Profit[2] .		£ 1,500	19.. Dec. 31	By Goods sent to Branches Account.		£ 1,900
	,, Balance— 25% on £1,600 .	c/d	400				
			£1,900				£1,900
				19.. Jan. 1	By Balance . . .	b/d	400

[1] i.e. 25 per cent on selling price = 33⅓ per cent on cost price; i.e. £6,300 + £2,100 = £8,400.

[2] i.e. 25 per cent on Sales, £6,000.

Dr. **BRIGHTON BRANCH DEBTORS** Cr.

			£				£
19.. Dec. 31	To Brighton Branch Stock Account—Sales . . .		2,000	19 . Dec 31	By Cash . . .		1,600
					„ Balances . .	c/d	400
			£2,000				£2,000
19 Jan. 1	To Balances . . .	b/d	400				

Dr. **GOODS SENT TO BRANCHES** Cr.

			£				£
19. Dec 31	To Brighton Branch Stock Account . .		800	19 Dec 31	By Brighton Branch Stock Account .		8,400
	„ Brighton Branch Adjustment Account—25% on £7,600		1,900				
	„ Head Office Purchases Account—75% on £7,600 .		5,700				
			£8,400				£8,400

Dr. **BRIGHTON BRANCH EXPENSES** Cr.

			£				
19 Dec. 31	To Brighton Branch Cash Account . .		300				

Dr. **BRIGHTON BRANCH CASH** Cr.

			£				£
19 Dec. 31	To Brighton Branch Stock Account Cash Sales		4,000	19. Dec. 31	By Brighton Branch Expenses Account .		300
	„ Brighton Branch Debtors . .		1,600		„ Head Office . .		5,300
			£5,600				£5,600

Note If £50 cash had been retained by the branch to meet current expenditure, there would be a balance (debit) of £50 on the Branch Cash Account, the amount of cash remitted to the Head Office being reduced to £5,250.

The cost plus percentage method will be treated in exactly the same manner so far as the accounts are concerned, but there will almost inevitably be a discrepancy between the balancing figure on the Branch Stock Account and the actual stock in hand. The treatment of these and other differences will now be dealt with, it being similar whether the cost plus percentage or the selling price system is in force.

Goods in Transit. Where goods are lost in transit the head office accounts will, where the loss arises in the transit to the branch, be adjusted by debiting the *cost* price of the goods to a special account, called Goods Lost in Transit Account, and the *loading* to Branch Adjustment Account, the total loaded price being credited to Branch Stock Account. At the same time the transfer from Goods Sent to

Branches Account in respect of the cost price of the goods sent (and lost) should be credited to Head Office Purchases Account. If the loss is covered by insurance, the amount in Goods Lost in Transit Account will be transferred to the debit of the Insurance Company, otherwise the loss will be debited to the Branch Profit and Loss Account or the Head Office Profit and Loss Account, according to whether the branch or the head office is at fault.

Illustration. Goods costing £1,600 are sent to branch, loading being 20 per cent of selling price (or 25 per cent of cost). During transit the whole consignment is lost. Show Ledger entries in the head office books.

Head Office books—

Dr. BRANCH STOCK *Cr.*

		£		£
	To Goods .	2,000	By *Branch Adjustment Account* . .	*400*
			,, *Goods Lost in Transit Account* . .	*1,600*
		£2,000		*£2,000*

Dr. GOODS SENT TO BRANCHES *Cr.*

		£		£
	To Branch Adjustment Account . .	400	By Branch Stock Account	2,000
	,, Head Office Purchases Account . .	1,600		
		£2,000		£2,000

Dr. BRANCH ADJUSTMENT ACCOUNT *Cr.*

		£		£
	To *Branch Stock Account—re Goods lost in transit*	*400*	By Goods sent to Branches Account.	400

Dr. GOODS LOST IN TRANSIT *Cr.*

		£		
1	To *Branch Stock Account—re Goods lost in transit*	*1,600*		

The adjusting entries are shown in italics.

Where the goods are lost in transit from the branch to the head office, the entries will be made as for returns from branch (as if they had actually reached the head office), and the loss recorded by debiting Goods Lost in Transit Account and crediting Trading Account with the cost price of the goods under the heading of Stock. A transfer from Goods Lost in Transit Account will be made to

[1] If fully insured, this amount will be transferred to the debit of the Insurance Company; otherwise to the debit of Branch Profit and Loss Account or Head Office Profit and Loss Account.

the Insurance Company if the loss is covered by insurance, otherwise the loss will be debited to the Branch Profit and Loss Account or the Head Office Profit and Loss Account.

Illustration. Goods costing £1,600 are sent to branch, loading being 20 per cent of selling price. The whole of the goods are returned to head office, and during reconveyance are lost. Show Ledger entries in the head office books.

Head Office books—

Dr. BRANCH STOCK *Cr*

		£			£
To Goods sent to Branches		2,000	By Returns .		2,000

Dr. GOODS SENT TO BRANCHES *Cr.*

		£			£
To Branch Stock Account— Goods returned .		2,000	By Branch Stock Account— Goods sent . .		2,000

Dr. GOODS LOST IN TRANSIT *Cr.*

		£			
To Trading Account .		1,600			

Dr. TRADING ACCOUNT (*includes*) *Cr.*

					£
			By Stock lost in transit .		1,600

Handling Charges. Where the head office charges out goods to the branch loaded with a nominal percentage to cover cost of handling, the same principles, as already outlined, are applicable.

Illustration. A limited company has its head office in London and a branch in Birmingham. The head office supplies the branch with all its goods, which are charged out at cost, plus 10 per cent to cover the cost of handling.

The branch sales are for cash, and no provision is made in the system of book-keeping for credit sales at the branch, but in actual practice limited credit is given in a few selected cases. All takings are paid into the bank for the credit of head office.

Show how the following items relating to the branch would appear in the Head Office Ledger, and close off the accounts concerned—

	£
Stock—1st January, 19.. (at cost to Branch) .	2,200
Cash received from Debtors during the year . . .	20,000
Debtors—1st January, 19..	80
Goods sent to Branch during the year (at cost to Head Office) .	14,000
Debtors—31st December, 19..	100
Stock—31st December, 19.. (at cost to Branch) .	1,980

Head Office books—

Dr. BIRMINGHAM BRANCH STOCK **Cr.**

			£				£
19..				19..			
Jan. 1	*To Stock* . . .	*b/d*	*2,200*	Dec. 31	By Sales . . .		20,020
Dec. 31	,, Goods sent to Branch (Birmingham) Account .		15,400		,, Balance . .	c/d	1,980
	,, Gross Profit . .	(*a*)	4,400				
			£22,000				£22,000
19..							
Jan. 1	To Balance . .	b/d	1,980				

Dr. BIRMINGHAM BRANCH DEBTORS **Cr.**

			£				£
19 .				19 .			
Jan. 1	*To Balances* . . .	*b/d*	*80*	Dec. 31	By Cash . . .		20,000
Dec. 31	,, Sales . . .		20,020		,, Balances . .	c/d	100
			£20,100				£20,100
19..							
Jan. 1	To Balances . .	b/d	100				

Dr. GOODS SENT TO BRANCH (BIRMINGHAM) **Cr.**

			£				£
19 .				19 .			
Dec 31	To Purchases Account.		14,000	Dec. 31	By Birmingham Branch Stock Account .		15,400
	,, Birmingham Branch Adjustment Account . .		1,400				
			£15,400				£15,400

Dr. BIRMINGHAM BRANCH ADJUSTMENT ACCOUNT **Cr.**

			£				£
19..				19 .			
Dec. 31	To Trading Account—10% on cost of Goods sold .	(*b*)	1,420	*Jan. 1*	*By Balance* . .	*b/d*	*200*
	,, Balance, being 10% of £1,800 . .	c/d	180	Dec. 31	,, Goods sent to Branch (Birmingham) Account .		1,400
			£1,600				£1,600
				19 .			
				Jan. 1	By Balance . .	b/d	180

Note. Items in italics are opening balances.

Reconciliation of Profit—

	£
Cost of the goods sold—	
Beginning Stock . . .	2,000
Plus Transfers . . .	14,000
	16,000
Less Closing Stock . .	1,800
Cost	£14,200
Sales	20,020
Cost	14,200
Profit [see (*a*) and (*b*)]	£5,820

The profit is made up of items marked (*a*) and (*b*) above.

The item of £1,420 will be credited to the appropriate account recording the handling charges.

It should be remembered, in dealing with the accounts of subsequent periods, that the balance on Branch Adjustment Account at the end of the preceding year must be duly taken into account.

Illustration. Goods are *invoiced* in the first year to a new branch at £2,400, being cost price plus 20 per cent on cost. The sales by branch are: cash, £210; credit, £1,800. The stock on hand at loaded price is £390. Bad debts written off are £200, and discounts allowed to debtors, £50; £1,300 is received from debtors, and all proceeds are remitted to head office intact.

In the second year goods *costing* £1,440 are sent to the branch, while total sales are £1,980 (£100 cash sales). The stock on hand at loaded price is £108. Discounts allowed to debtors are £100. £50 cash received has not yet been remitted by the branch. Closing debtors, £130. There is a discrepancy between the balance on the Branch Stock Account and the actual value (at selling price) of the stock in hand, the Branch Stock Account recording £30 in excess.

Show Ledger Accounts in the head office books.

Head Office books—

Dr. BRANCH STOCK *Cr.*

			£				£
Year 1	To Goods sent to Branches Account		2,400	Year 1	By Sales— Branch Cash Account		210
					Branch Debtors		1,800
					,, Balance	c/d	390
			£2,400				£2,400
Year 2	To Balance	b/d	390	Year 2	By Sales— Branch Cash Account		100
	,, Goods sent to Branches Account		1,728		Branch Debtors		1,880
					,, *Branch Stock Shortage Account*		*30*
					,, Balance	c/d	108
			£2,118				£2,118
Year 3	To Balance	b/d	108				

Dr. GOODS SENT TO BRANCHES *Cr.*

			£				£
Year 1	To Branch Adjustment Account		400	Year 1	By Branch Stock Account		2,400
	,, Purchases (or Trading) Account		2,000				
			£2,400				£2,400
Year 2	To Branch Adjustment Account		288	Year 2	By Branch Stock Account		1,728
	,, Purchases (or Trading) Account		1,440				
			£1,728				£1,728

Dr. BRANCH ADJUSTMENT ACCOUNT **Cr.**

			£				£
Year 1	To Branch Profit and Loss Account	(*a*)	335	Year 1	By Goods sent to Branches Account		400
	„ Balance	c/d	65				
			£400				£400
Year 2	To *Branch Stock Shortage Account*		*5*	Year 2	By Balance	b/d	65
	„ Branch Profit and Loss Account	(*b*)	330		„ Goods sent to Branches Account		288
	„ Balance	c/d	18				
			£353				£353
				Year 3	By Balance	b/d	18

Dr. BRANCH DEBTORS **Cr.**

			£				£
Year 1	To Branch Stock Account		1,800	Year 1	By Branch Cash Account		1,300
					„ Bad Debts		200
					„ Discounts		50
					„ Balances	c/d	250
			£1,800				£1,800
Year 2	To Balances	b/d	250	Year 2	By Branch Cash Account		1,900
	„ Branch Stock Account		1,880		„ Discounts		100
					„ Balances	c/d	130
			£2,130				£2,130
Year 3	To Balances	b/d	130				

Dr. BRANCH CASH **Cr.**

			£				£
Year 1	To Branch Debtors		1,300	Year 1	By Head Office		1,510
	„ Branch Stock Account		210				
			£1,510				£1,510
Year 2	To Branch Debtors		1,900	Year 2	By Head Office		1,950
	„ Branch Stock Account		100		„ Balance	c/d	50
			£2,000				£2,000
Year 3	To Balance	b/d	50				

Dr. BRANCH STOCK SHORTAGE ACCOUNT **Cr.**

			£				£
Year 2	To *Branch Stock Account*		*30*	Year 2	By *Branch Adjustment Account*		*5*
					„ *Branch Profit and Loss Account*		*25*
			£30				*£30*

The gross profit = 20% of cost or $16\frac{2}{3}$% of selling price.

(*a*) 1st year: $\frac{1}{6} \times £2{,}010 = £335$
(*b*) 2nd year: $\frac{1}{6} \times £1{,}980 = £330$.

Double-column Method. Instead of maintaining separate Branch Stock Accounts and Branch Adjustment Accounts, it is possible to open one account ruled with double columns, one to record the goods at the loaded or selling price (which is merely memorandum, the entries therein not being part of the double entry system), and the other to record the double entry detail, including the purchases and stock figures at cost price and the sales at selling price in the ordinary way.

Illustration. The Bristol branch of A, Ltd., to which goods are invoiced at 25 per cent above cost, has the following transactions for the year to 31st December, 19..—

	£	
Stock on hand at 1st January, 19..	1,000	(invoice price)
Stock on hand at 31st December, 19...	4,600	(,,)
Goods from Head Office during year	20,000	(,,)
Sales for year	16,400	
Discounts allowed	400	
Cash remitted to Head Office during year	16,000	

The Double-column Branch Account will then be as follows—

Dr. BRISTOL BRANCH *Cr.*

			Invoice Price					Invoice Price	
19 .			£	£	19			£	£
Jan. 1	To Balance	b/d	1,000	800	Dec. 31	By Sales—Branch Debtors		16,400	16,400
Dec. 31	,, Goods sent to Branches Account		20,000	16,000		,, Balance: Stock	c/d	4,600	3,680
	,, Gross Profit transferred to Branch Profit and Loss Account			3,280					
			£21,000	£20,080				£21,000	£20,080
19 .									
Jan 1	To Balance	b/d	4,600	3,680					

The other accounts require no special comment.

The employment of the Branch Adjustment Account method will produce an identical result, thus—

Dr. BRANCH ADJUSTMENT ACCOUNT *Cr.*

19 .			£	19..			£
Dec. 31	To Branch Profit and Loss Account [20% on £16,400]		3,280	Jan 1	By Balance	b/d	200
	,, Balance [20% on £4,600]	c/d	920	Dec. 31	,, Goods sent to Branches Account		4,000
			£4,200				£4,200
				19..			
				Jan. 1	By Balance[1]	b/d	920

Any difference in the stock arising during the year would be inserted in the invoice column at its nominal selling value, the actual amount when discovered being inserted in the main column and from there transferred to a special loss account or to Profit and

[1] This item (if the loaded price were charged to Branch) would be offset against the Stock of £4,600, leaving a net figure of £3,680.

Loss Account unless covered by insurance, when the transfer would be made to the debit of the insurance company. (See page 427.)

Alternative Method—

Where the gross profit of a branch is not required to be ascertained separately, although the selling price is uniform, the procedure is to employ a Branch Stock Account and a Goods Sent to Branches Account. No Branch Adjustment Account is possible, if the cost price of the goods sent to branches is not recorded. The method is as follows—

(1) Debit Branch Stock at selling price Credit Goods sent to Branches	for Goods sent to Branch
(2) Reverse of (1)	for returns *from* Branch
(3) Debit Cash or Debtors Credit Branch Stock	for Branch Sales
(4) Debit Branch Stock Credit Debtors	for returns *to* Branch
(5) Balance off Branch Stock at selling price	for closing Stock at selling price
(6) Debit Goods sent to Branches Credit Branch Trading Account	for Branch net Sales
(7) Balance off Goods sent to Branches at selling price	for closing Stock at selling price

(8) The effect of the entries under (5) and (7) is to eliminate closing Stock from the accounts, so that closing Stock at cost will be introduced into the Trading Account in the ordinary way.

(9) Any shortage of stock at the branch will be debited to Goods sent to Branches and credited to Branch Stock at selling price; such loss being shown by debiting Branch Profit and Loss Account and crediting Branch Trading Account at cost.

The employment of the two accounts mentioned above results in a check on stock. The two accounts are reciprocal except that the credit for Sales in the Branch Stock Account is reflected in a debit to branch debtors or cash, and the debit for sales in the Goods sent to Branches Account is reflected in the credit to Branch Trading Account. In other words, the net result is that the branch debtors or cash will be debited and the Branch Sales Account credited. The opening and closing branch stock at cost (or market value, if lower) will be brought into the Branch Trading Account in the usual way and the general Purchases Account will remain undisturbed, if the transfer figure is not disclosed in the question (see page 427). Otherwise, Branch Purchases Account will be debited and general Purchases Account credited.

Illustration. Goods are sent to branch loaded with $33\frac{1}{3}$ per cent on *cost*, invoiced at £2,000. Branch Returns to head office, £200; Sales by branch, £1,870; Returns to branch, £470. Stock (at price charged to branch) £400. Show accounts in the head office books.

Head Office books (the numbers in brackets refer to the foregoing rules)—

Dr. BRANCH STOCK *Cr.*

				£					£
	To Goods	(1)		2,000		By Returns	(2)		200
	„ Returns	(4)		470		„ Sales	(3)		1,870
						„ Balance	(5)	c/d	400
				£2,470					£2,470
	To Balance		b/d	400					

Dr. **BRANCH TRADING ACCOUNT** *Cr.*

		£			£
To Purchases[1]		1,350	By *Sales* . . 1,870 Less *Returns* . 470	(6)	*1,400*
,, Gross Profit		350	,, Stock		300
		£1,700			£1,700

Dr. **GOODS SENT TO BRANCHES** *Cr.*

		£			£
To Returns . . (2)		200	By Branch Stock . (1)		2,000
,, *Branch Trading and Profit and Loss Account* . (6)		*1,400*			
,, Balance—Stock. (7)	c/d	400			
		£2,000			£2,000
			By Balance .	b/d	400

As the Branch Stock Account and Goods sent to Branches Account are self-effacing, the ordinary entries are necessary for the preparation of the Branch Trading Account.

Notes—

(1) Expenses ignored.

(2) Percentage to be deducted from selling price is 25 per cent [i.e ⅓ of cost price = ¼ of selling price]: therefore Stock is £400 less £100 = £300.

If compiled in the usual way, the accounts would be—

Dr **BRANCH STOCK** *Cr.*

		£			£
To Goods		2,000	By Returns .		200
,, Returns		470	,, Sales		1,870
			,, Balance .	c/d	400
		£2,470			£2,470
To Balance	b/d	400			

Dr. **GOODS SENT TO BRANCHES** *Cr.*

		£			£
To Branch Stock Account—Returns.		200	By Branch Stock Account		2,000
,, Purchases (or Trading) Account		1,350			
,, Branch Adjustment Account		450			
		£2,000			£2,000

[1] Goods sent less returns, at selling price— £1,800, less £450.

Dr. BRANCH ADJUSTMENT ACCOUNT *Cr.*

			£			£
To Branch Profit and Loss Account . .		350	By Goods sent to Branches Account.		450
,, Balance . . .	c/d	100			
		£450			£450
			By Balance . .	b/d	100

Dr. PURCHASES *Cr.*

					£
			By Goods sent to Branches Account.		1,350

Dr. BRANCH PROFIT AND LOSS ACCOUNT *Cr.*

					£
			By Branch Adjustment Account . .		350

Illustration. Head office invoiced to their Birmingham Branch during the year goods at selling price amounting to £7,400. The credit sales of the branch were £3,100 and cash sales £1,700. The branch returned £200 stock at selling price, and had returned from customers £100. The discounts allowed to customers by the branch amounted to £120. The branch remitted to head office £3,860, being the amount of cash sales and receipts from customers. The beginning and closing stocks of the branch were £1,500 (cost £1,120) and £3,900 (cost £3,270). The branch had debtors of £1,200 at the beginning and £1,920 at the end. Loss through pilferage was ascertained to be £100. (Cost £80.)

The head office had beginning and ending stock of £13,000 and £17,000. The purchases (*less* returns) and sales (*less* returns) during the year were £31,300 and £37,200.

Write up the necessary accounts to record the above in the head office books by the foregoing method, and show the gross profit of the business for the year.

Head Office books—

Dr. BRANCH STOCK *Cr.*

		£			£
To Balance . . .	b/d	1,500	By Cash Sales . .		1,700
,, Goods from Head Office		7,400	,, Credit Sales . .		3,100
,, Returns from Customers . . .		100	,, Loss through Pilferage[1] . . .		100
			,, Returns to Head Office . . .		200
			,, Balance . . .	c/d	3,900
		£9,000			£9,000
To Balance . . .	b/d	3,900			

[1] See rule 9, page 422.

Dr. GOODS SENT TO BRANCHES *Cr.*

		£			£
To Returns		200	By Balance	b/d	1,500
,, Transfer to Trading Account		4,700	,, Branch Stock Account		7,400
,, Loss through Pilferage		100			
,, Balance—Stock	c/d	3,900			
		£8,900			£8,900
			By Balance	b/d	3,900

Dr. BRANCH DEBTORS *Cr.*

		£			£
To Balance	b/d	1,200	By Cash		2,160
,, Credit Sales		3,100	,, Discounts		120
			,, Returns		100
			,, Balances	c/d	1,920
		£4,300			£4,300
To Balances	b/d	1,920			

Dr. TRADING ACCOUNT *Cr.*

	£	£		£	£
To Opening Stock—			By Sales (net)—		
Head Office	13,000		Head Office	37,200	
Branch	1,120		Branch	4,700	
		14,120			41,900
,, Purchases (net)		31,300	,, Closing Stock—		
,, Gross Profit to Profit and Loss Account		16,830	Head Office	17,000	
			Branch	3,270	
					20,270
			,, Loss of Stock by Pilferage[1]		80
		£62,250			£62,250

A modification of this method is to use only the Branch Account (in place of Branch Stock, Branch Cash, and Branch Debtors Account) and Goods sent to Branch Account. Although it is preferable to use the full accounts, the net result will be the same.

The entries will be—

(1)	Debit Branch at selling price Credit Goods sent to Branch	for transfers of Goods to Branch
(2)	Reverse of (1)	for returns from Branch.
(3)	Debit Cash Credit Branch	for remittances by Branch to Head Office.
(4)	Debit Branch Expenses (including Bad Debts) Credit Branch	for expenses paid by Branch.
(5)	Bring down as balances on Branch Account closing cash at Branch, Debtors, and Stock at selling price.	
(6)	Debit Goods sent to Branch Credit Branch Trading Account	for Branch Sales.

[1] This item will be debited to the Profit and Loss Account.

(7) Debit Branch Expenses Credit Head Office Cash	for expenses paid by Head Office for Branch.
(8) Bring down the balance of Goods sent to Branch Account which will offset Stock brought down in (5).	
(9) Closing Stock (having been eliminated as shown in (8)) will appear in the final accounts at cost, subject to any provision for lower value, in the usual way.	
(10) Debit Branch Profit and Loss Account Credit Branch Expenses	for amounts in debit in (4) and (7).

Illustration. During the year a Branch was opened and the following particulars are ascertained—

	£
(1) Goods sent to Branch at selling price	2,300
(2) Goods returned by Branch at selling price	100
(3) Closing Debtors, after deducting Bad Debts £50	200
(4) Expenses paid by Branch	40
(5) Expenses paid by Head Office for Branch	170
(6) Petty Cash on hand	10
(7) Closing stock at selling price	440

Show Branch Account and Goods sent to Branch Account in the Head Office books.

Dr. BRANCH *Cr.*

		£			£
To Goods[1]		2,300	By Returns to H O		100
			,, Remittance to H O		1,460
			,, Bad Debts		50
			,, Expenses		40
			,, Balances c/d—		
			Goods[1]	£440	
			Cash	10	
			Debtors	200	
					650
		£2,300			£2,300
To Balances b/d—					
Goods[1]	£440				
Cash	10				
Debtors	200				
		650			

Dr. GOODS SENT TO BRANCH *Cr.*

	£		£
To Branch (Returns)	100	By Branch (Transfer)	2,300
,, Branch Trading Account: Sales	1,760		
,, Branch Stock[1] c/d	440		
	£2,300		£2,300
		By Branch Stock[1] b/d	440

[1] At selling price.

The item £170 will not appear in the above accounts and the items of £440 cancel each other and stock at cost (or market value if less) will be debited to Branch Stock Account and credited to Branch Trading Account.

The debit to Branch Account for goods at selling price will, or should, equal the sum of the remittances and returns by Branch to Head Office, Bad Debts, Expenses paid, and the increase (or decrease) in the closing stock, cash and debtors.

If there is an excess of debits over credits in the Branch Account, it will represent a deficiency (or a surplus in the converse case).

If the accounts were written up in the ordinary way, they would be as follows (abbreviated in form)—

Branch Stock

Dr.	£	Cr.	£
Goods (S.P.)	2,300	Returns	100
		Credit Sales	1,760[1]
		Stock (S.P.)	440

Debtors

Dr.	£	Cr.	£
Branch Stock	1,760	Cash	1,510
		Bad Debts	50
		Balance	200

Branch Cash

Dr.	£	Cr.	£
Debtors	1,510	H.O.	1,460
		Expenses	40
		Balance	10

Branch Expenses

Dr.	£	Cr.	£
Branch Cash	40		
H.O.	170		

Differences in Balance of Stock. It will often be found in practice that there is a difference between the actual stock held by the branch and the balance shown by the Branch Stock Account, and the cause of such discrepancy must be ascertained before the difference can be treated in the books. It may arise from many different reasons, some of which are—

(1) Error in the percentage of loading.

(2) The sale of the goods below or above the estimated selling price.

(3) Omission of returns and allowances.

(4) Loss of stock (rain, fire, etc.), or theft.

(5) Errors in stocktaking.

[1] Even if some of these sales were for cash instead of credit, the result would be the same.

Assuming that the balance brought down on the Branch Stock Account is £100 in excess of the physical stock held by the branch, and that the goods are loaded by 25 per cent on cost when invoiced to the branch, the discrepancy being due to theft, the real loss to the firm will only be £80, as 20 per cent of the invoiced price is loading. To bring this into account (*a*) the Branch Stock Account must be credited with £100, as must be done in all cases because the stock has "gone out," and as this stock is not in hand there must be no debit balance brought down in respect of it; (*b*) Branch Stock Shortage Account must be debited with £80 (the actual loss); and (*c*) Branch Adjustment Account must be debited with the £20 loading (as this represents cancellation of anticipated profit which cannot materialize).

The adjusting entries would be as follows—

		£	£
Branch Stock Shortage	*Dr.*	80	
Branch Adjustment	*Dr.*	20	
Branch Stock	*Cr.*		100

Alternatively, £100 may be transferred to the debit of Branch Stock Shortage Account and £20 transferred therefrom to the debit of Branch Adjustment Account.

The claim (if any) against an insurance company in respect of the loss would be set off against the Branch Stock Shortage Account, and the balance of this account would be written off to the debit of Branch Profit and Loss Account.

If the loss has arisen from a theft of cash, the actual loss is £100, and accordingly the entries are—

(1) Where the cash has been entered:

		£	£
Branch Cash Shortage	*Dr.*	100	
Branch Cash	*Cr.*		100

(2) Where no cash entry has been made:

Branch Cash Shortage	*Dr*	100	
Branch Stock (cash sales)	*Cr.*		100
or			
Branch Debtors (credit sales)	*Cr.*		100

If the loss has arisen from bad debts, or discounts allowed to customers, the actual loss is £100, and the entries are—

(1) Where no Debtors Accounts are kept, although credit sales are made—

		£	£
Branch Profit and Loss Account	*Dr.*	100	
Branch Stock	*Cr.*		100

(2) Where Debtors Accounts are kept—

Branch Profit and Loss Account	*Dr.*	100	
Branch Debtors	*Cr.*		100

If the loss has arisen from allowances made to customers, the actual loss is £100, and the entries are—

		£	£
Branch Adjustment	*Dr.*	100	
Branch Stock	*Cr.*		100

It may be that the balance shown by the Branch Stock Account is less than the value of the actual stock (at selling price) held by the branch. In the absence of any special reason, this will generally be due to the fact that the loading is insufficient to cover the full difference between cost and selling price, and accordingly the estimated profit in the Branch Adjustment Account is ***understated***. The correcting entry is to debit the full amount of the difference to Branch Stock Account and to credit it to Branch Adjustment Account.

In examinations, unless additional facts are given (*vide infra*), or the question specially deals with such differences, any profit or loss should always be transferred to the Branch Adjustment Account in the Head Office books, with a note as to alternative treatments.

Where from information in a question the inference is that the branch may perform a certain amount of work on the goods received in respect of some of the sales, and there is more stock in hand (at selling price) than is shown by the balance of the Branch Stock Account, a probable cause of the discrepancy is that the branch has charged customers for the proportion of the wages bill attributable to such work.

Depreciation. Depreciation, where the Branch accounts are kept at the Head Office, will be recorded by debiting Branch Profit and Loss Account and crediting the particular Branch Asset.

Illustration. Goods are invoiced to a newly-opened branch by head office at £4,600, representing cost plus 25 per cent. Returns to head office are £50; Branch Sales (cash), £4,230, all of which is remitted to head office except the sum of £400 for current trading expenses. Stock at end at selling price, £300. The head office has furnished cash for purchase of Fixtures, etc., £900. Expenses paid by head office on behalf of the branch, £100. Write £65 off fixtures and show accounts in the head office books.

Dr. BRANCH STOCK *Cr.*

		£			£
To Goods		4,600	By Returns		50
			,, Sales		4,230
			,, Branch Adjustment (or Stock Shortage) Account		20
			,, Balance	c/d	300
		£4,600			£4,600
To Balance	b/d	300			

Dr. GOODS SENT TO BRANCHES *Cr.*

		£			£
To Branch Stock Account Returns		50	By Branch Stock Account		4,600
,, Branch Adjustment Account		910			
,, Purchases (or Trading) Account		3,640			
		£4,600			£4,600

Dr. **Branch Adjustment Account** *Cr.*

			£			£
	To Branch Stock Account Shortage[1]		20	By Goods Sent to Branches Account		910
	,, Gross Profit to Branch Profit and Loss Account		846	,, Shortage of Stock (*at Cost*) to Branch Profit and Loss Account[1]		16
	,, Balance	c/d	60			
			£926			£926
				By Balance[2]	b/d	60

Dr. **Branch Cash** *Cr.*

			£			£
	To Sales		4,230	By Expenses[3]		400
				,, Remittances[4]		3,830
			£4,230			£4,230

Dr. **Branch Profit and Loss Account** *Cr.*

			£			£
	To Cash— Expenses (detailed)		100	By Gross Profit		846
	,, Branch Expenses		400			
	,, Stock Shortage		16			
	,, Depreciation of Fixtures		65			
	,, Net Profit to General Profit and Loss Account		265			
			£846			£846

Dr. **Branch Fixtures** *Cr.*

			£			£
	To Cash		900	By Branch Profit and Loss Account		65
				,, Balance	c/d	835
			£900			£900
	To Balance	b/d	835			

Sundry Adjustments. Where, as often happens, goods are consigned to a particular branch by error, and are consigned therefrom to the branch to which they should originally have been dispatched, the transfer must be dealt with in the accounts of both branches. The goods should be considered as having been returned from the first branch to head office and re-consigned to the second branch.

Illustration. £1,000 goods are inadvertently sent to Branch A instead of to Branch B. Upon instructions from head office they

[1] True shortage is £20, less loading of 20% of £20 = £16
[2] 20% of £300.
[3] Actually a detailed Expenses Account would be opened.
[4] Debited to Cash Account.

are sent direct from Branch A to Branch B. The entries therefore are in Journal form—

Goods sent to Branch A	*Dr.*	£1,000	
To Branch A Stock			£1,000
Branch B Stock	*Dr.*	£1,000	
To Goods sent to Branch B . . .			£1,000

In certain circumstances (e.g. owing to locality) goods may be loaded up to different branches at different rates, e.g. the cost price may be loaded to Branch A at 10 per cent and to Branch B at 20 per cent. Where such a procedure operates, particular care is needed in dealing with transfers from one branch to another because the goods are evaluated at different prices for each branch, necessitating a recalculation of the cost price and invoice price according to the loading required for the branch in question.

If goods are sent to Branch A, loaded and charged to it at a figure which is correct for Branch B (the branch to which the goods should originally have been dispatched), a simple transfer is made as already illustrated, because Branch B is by the transfer correctly debited, while the incorrect debit to Branch A is exactly eliminated. If, however, goods are sent to Branch A (instead of to B) and loaded with the percentage applicable to A, the transfer to B upon the goods being re-directed to B will be effected as follows: (1) the incorrect debit to A will be credited to A (eliminating the original entries); but (2) the debit to B must be at the loaded figure applicable to B. In other words, in the first case the entries required call for no adjustment in price, as the price was already correct as regards B; but in the second case the price must be adjusted, as it was incorrect as regards B.

Illustration. There are two branches, A and B. Goods are consigned to them at loaded figures of 20 per cent and 25 per cent on cost respectively. The invoices to the branches are £1,200 and £2,000 respectively. Included in the item £1,200 are invoices for goods costing £300, invoiced to Branch A at £360, which should have been invoiced to B. Sales are all for cash, being A, £720; B, £1,500.

Show the appropriate ledger entries in the head office books. It may be assumed that the closing stocks are correct.

Dr. BRANCH STOCK *Cr.*

		A	B			A	B
		£	£			£	£
To Goods sent to Branches Accounts		1,200	2,000	By Goods sent to Branches Account.		360	
" do do.	(a)		375	" Sales		720	1,500
				" Balances	c/d	120	875
		£1,200	£2,375			£1,200	£2,375
To Balances	b/d	120	875				

Dr. GOODS SENT TO BRANCHES *Cr.*

			A	B				A	B
			£	£				£	£
	To Branch Stock Account .		360			By Branch Stock Accounts .		1,200	2,000
	„ Branch Adjustment Accounts		140	475		„ do. do. .			375
	„ Purchases (or Trading) Account .		700	1,900					
			£1,200	£2,375				£1,200	£2,375

Dr. BRANCH ADJUSTMENT ACCOUNTS *Cr.*

			A	B				A	B
			£	£				£	£
	To Branch Profit and Loss Accounts	(b)	120	300		By Goods sent to Branches Accounts .		140	475
	„ Balances.	c/d	20	175					
			£140	£475				£140	£475
						By Balances . .	b/d	20	175

Notes. (*a*) The goods costing £300 will be charged up to A at £300 + $\frac{1}{5}$ = £360, and to B at £300 + $\frac{1}{4}$ = £375. The transfers from Goods sent to Branches Accounts to Branch Adjustment Accounts are made in total as follows: For A, $\frac{1}{6}$ (£1,200 − £360) = £140; for B, $\frac{1}{5}$ (£2,000 + £375) = £475 [$\frac{1}{5}$ of cost price = $\frac{1}{6}$ of selling price and $\frac{1}{4}$ of cost price = $\frac{1}{5}$ of selling price]. The balances carried down in the Branch Adjustment Accounts on the stocks outstanding are calculated similarly A, $\frac{1}{6}$, B, $\frac{1}{5}$. The figures in the Branch Accounts are at SELLING price, therefore the "loading down" fractions are respectively $\frac{1}{6}$ and $\frac{1}{5}$ of selling price.

(*b*) The gross profits are: (i) $\frac{1}{6}$ of £720 = £120; (ii) $\frac{1}{5}$ of £1,500 = £300.

Adjustments in Respect of Price Changes. As has been seen, the stocks at branches are shown at loaded prices, whether at selling price or at cost price plus a percentage, and consequently if there is to be an increase or a decrease in the selling price an adjustment must be passed through the books in respect thereof.

The adjustments for price change may best be explained by the use of illustrations.

Illustration. The balance of Branch Stock Account at 1st January, 19.., is £2,200 (to represent a profit of 10 per cent on cost price). As and from 1st January, 19.., the price is to be increased so that there is to be earned a profit of 12½ per cent on cost price. Make the required adjustments.

Dr. BRANCH STOCK *Cr.*

			£				
	To Balance . . .	b/d	2,200				
	„ Branch Adjustment Account *re* Selling Price Adjustment .		50				

Dr. **Branch Adjustment Account** Cr.

							£
				By Balance . . .	b/d		200
				„ Branch Stock . .			50

The *old* provision was—

	£		£
$\frac{1}{11}$ × selling price of . . .	2,200	=	200
or			
$\frac{1}{10}$ × cost price of. . . .	2,000	=	200

The *new* provision is—

$\frac{1}{9}$ × revised selling price of . .	2,250	=	250
or			
$\frac{1}{8}$ × cost price of. . . .	2,000	=	250

The revised selling price is arrived at thus—

	£
Cost of Goods	2,000
Loading of $12\frac{1}{2}$% thereof. . . .	250
Revised Selling Price	£2,250

Where the selling price is to be reduced reverse entries will be required, the Branch Adjustment Account being debited and the Branch Stock Account credited with the appropriate reduction of the provision on unsold stock.

Illustration. Assuming the same facts as in the foregoing question, except that the new selling price is to be such as to give a profit of 5 per cent on cost price, show the necessary adjustments.

Dr. **Branch Stock** Cr.

			£				£
	To Balance . . .	b/d	2,200		By Branch Adjustment Account *re* Selling Price Adjustment .		100

Dr. **Branch Adjustment Account** Cr.

			£				£
	To Branch Stock .		100		By Balance . . .	b/d	200

The *old* provision was –

	£		£
$\frac{1}{11}$ × selling price of . .	2,200	=	200
or			
$\frac{1}{10}$ × cost price of .	2,000	=	200

The *new* provision is –

$\frac{1}{21}$ × revised selling price of . .	2,100	=	100
or			
$\frac{1}{20}$ × cost price of . . .	2,000	=	100

The revised selling price is arrived at thus—

	£
Cost of Goods	2,000
Loading of 5% thereof	100
Revised Selling Price	£2,100

Hence, the Branch Stock Account must be reduced by £100 as must the Branch Adjustment Account.

As the cost is in nowise affected, the above transfer will not alter the amount shown in the Balance Sheet, as before the transfer was made the stock would be shown as £2,200 less Branch Adjustment Account £200 = £2,000. After the adjustment it will appear as £2,100, less Branch Adjustment Account £100 = £2,000.

Where there is an alteration in the cost price it may be that the branch is to earn the same *rate* of gross profit, or an *altered* rate (corresponding with the increased or decreased cost price), or the same AMOUNT of profit per quantity sold.

The same principles will apply whether the alteration is an increase or decrease. The problem lies in the ascertainment of the AMOUNT that is to be transferred, as the book-keeping is simple, i.e. a transfer from Branch Stock Account to Branch Adjustment Account.

A decrease in price will now be illustrated.

Illustration. The following are the balances of the branch in the head office books at 1st July—

Dr. BRANCH STOCK *Cr.*

		£			
To Balance . . .	b/d	2,000			

Dr. BRANCH ADJUSTMENT ACCOUNT *Cr.*

					£
			By Balance . . .	b/d	400

As on 1st July cost prices have fallen by 20 per cent and selling prices are to be adjusted accordingly. Show accounts in the head office books.

Dr. BRANCH STOCK *Cr.*

		(a) £	(b) £	(c) £			(a) £	(b) £	(c) £
To Balance	b/d	2,000	2,000	2,000	By Trading Account		320	320	320
,, Branch Adjustment Account			320		,, Branch Adjustment Account		80		
					,, Balance . .	c/d	1,600	2,000	1,680
		£2,000	£2,320	£2,000			£2,000	£2,320	£2,000
To Balance . .	b/d	1,600	2,000	1,680					

Dr. BRANCH ADJUSTMENT ACCOUNT *Cr.*

		(a) £	(b) £	(c) £			(a) £	(b) £	(c) £
To Branch Stock		80			By Balance .	b/d	400	400	400
„ Balance .	c/d	320	720	400	„ Branch Stock			320	
		£400	£720	£400			£400	£720	£400
					By Balance .	b/d	320	720	400

(*a*) **If the selling price is to be *reduced* by 20 per cent and the RATE of gross profit to remain the same.**

The cost is obviously £1,600, therefore the revised "cost" figure is £1,600, less 20 per cent of £1,600, i.e. £1,600 – £320 = £1,280. Hence, the revised selling price is £1,280 plus 25 per cent of £1,280 = £1,600. The amount of 25 per cent is added to cost because it is the equivalent of 20 per cent of selling price. Therefore the new loading will be 20 per cent of £1,600, or 25 per cent of £1,280, viz. £320. The transfer consequently will be—

Debit Trading Account, £320 }
Debit Branch Adjustment Account, £80 } Credit Branch Stock, £400

This will leave the branch stock at selling price at £1,600, and the Branch Adjustment Account at £320.

In the Balance Sheet the branch stock will be carried out at £1,280.

Future loading will be 25 per cent of cost.

(*b*) **If the selling price is to be *maintained* at original.**

As the figure of £2,000 is the selling price no alteration will be entailed in the Branch Stock Account, but as the revised "cost" figure is, as has been seen, £1,280, the Branch Adjustment Account will be increased by £320, as the loading is now correspondingly higher. As the "cost" figure is reduced, the adjustment must be considered as a loss.

The transfers consequently will be—

Debit Trading Account, £320: Credit Branch Stock, £320,
Debit Branch Stock, £320: Credit Branch Adjustment Account, £320.

The above entries may be curtailed by making the transfer without the intervention of the Branch Stock Account, thus—

Debit Trading Account, £320: Credit Branch Adjustment Account, £320.

In the Balance Sheet the branch stock will be carried out at £1,280, i.e. £2,000 (Branch Stock Account) less £720 (Branch Adjustment Account).

Future loading will be $\frac{720}{1280}$ of cost, i.e. $\frac{9}{16}$.

(*c*) **Where the same *amount* of profit is to be earned on quantity sold.**

As the revised cost is £1,280 and the same amount of profit on sales is to be earned, the selling price must be £1,680. Hence, the balance on Branch Adjustment Account remains undisturbed and the balance on the Branch Stock Account will be reduced from £2,000 to £1,680.

The transfer consequently will be—

Debit Trading Account, £320: Credit Branch Stock, £320

In the Balance Sheet the branch stock will be shown at £1,280.

Future loading will be $\frac{40}{128}$ of cost, i.e. $\frac{5}{16}$.

The three results may be shown in summary form as on pages 434 and 435.

In each case a book loss is entailed by virtue of the reduction in the value of the stock.

The difference between the two accounts is, in each case, £1,280, representing the revised cost figure of £1,600 *less* 20 per cent thereof.

The result in each case is shown as follows—

(*a*) The Selling Price is reduced by 20 per cent (i.e. from £2,000 to £1,600), and the Branch Adjustment Account is £320, being the loading of 20 per cent on £1,600.

(*b*) The Selling Price is maintained at the old figure, £2,000.

(*c*) The old loading figure of £400 is retained in the Branch Adjustment Account.

General Illustration. Barn & Sons are wholesale grocers with a head office (which is the warehouse as well as a selling department) and one branch. The control of buying and the accounting therefor are at head office. The branch sends weekly returns to head office, from which the branch accounting is performed, and pays its own sundry expenses (including wages), for which it is recouped weekly.

The general expenses at head office are apportioned between the warehouse and the head office selling department in the proportion 2 : 1. The warehouse charges out goods at 25 per cent on cost price. The handling charges incurred by warehouse are to be debited to the head office and branch at a "load" of 20 per cent of cost price of the goods sent to them. The transport costs are separately booked and charged to the head office selling department at a profit of 10 per cent on cost, and to branch at competitive rates.

The following are the details of the Head Office Bank Account—

Dr.	£		*Cr.* £
To Balance	1,000	By Payments—	
„ Receipts from—		General Expenses	2,700
H.O. Selling Dept.	10,400	Transport Creditors	700
Branch	4,300	Trade Creditors	8,000
		Sundry Expenses	1,680
		Warehouse	420

The following details are revealed from the branch returns and other books—

	Head Office £	Branch £
Petty Cash Balance at commencement	140	60
Sundry Expenses	1,210	470
Sales—Credit	9,000	4,800
Cash	1,900	600
Receipts from Debtors	8,500	3,700

	£
General Purchases	11,200
Goods charged at selling price from—	
Warehouse to Head Office	9,000
Warehouse to Branch	5,000
Transport costs to—	
Head Office	440
Branch	253
Closing Stock on hand—	
Head Office (Selling Price)	100
Branch (Selling Price)	480
Warehouse (Cost Price)	3,000
Sundry Creditors (*re* Transport) at end	120

The period relates to the year ended 31st December, 19..

The balances at commencement of the year were—

	Dr.	*Cr.*
	£	£
Sundry Assets—		
Warehouse	1,500	
Head Office	3,500	
Branch	1,000	
Stock—		
Warehouse (Cost Price)	3,000	
Head Office (Selling Price)	2,000	
Branch (Selling Price)	1,000	
Bank	1,000	
Stock Adjustment Accounts—		
Head Office		400
Branch		200
Petty Cash	200	
Sundry Creditors (including £200 *re* Transport)		5,400
Sundry Debtors—		
Head Office	2,300	
Branch	500	
Capital		10,000
	£16,000	£16,000

From the foregoing information prepare accounts, ignoring any question of drawings and depreciation.

Dr. **DEBTORS** *Cr.*

			H.O.	Branch				H.O.	Branch
			£	£				£	£
	To *Balances*	b/d	*2,300*	*500*		By Cash		8,500	3,700
	,, Sales		9,000	4,800		,, Balances	c/d	2,800	1,600
			£11,300	£5,300				£11,300	£5,300
	To Balances	b/d	2,800	1,600					

Dr. CAPITAL *Cr.*

			£				£
	To Net Loss from Profit and Loss Account		2,256		By *Balance* . .	b/d	*10,000*
	,, Balance . . .	c/d	7,744				
			£10,000				£10,000
					By Balance . .	b/d	7,744

Dr. BANK *Cr.*

			£				£
	To *Balance* . . .	*b/d*	*1,000*		By General Expenses:		
	,, H.O. Cash Sales		1,900		Warehouse .		2,700
	,, H.O. Debtors .		8,500		,, Transport . .		700
	,, Branch Cash Sales .		600		,, Creditors . .		8,000
	,, Branch Debtors .		3,700		,, Sundry Expenses .		1,680
					,, Warehouse . .		420
					,, Balance . .	c/d	2,200
			£15,700				£15,700
	To Balance .	b/d	2,200				

Dr. SUNDRY ASSETS *Cr.*

			W.	H.O.	Branch					
	To *Balances*	b/d	£ *1,500*	£ *3,500*	£ *1,000*					

Dr. GOODS SENT TO BRANCHES *Cr.*

			H.O.	Branch				H.O.	Branch
			£	£				£	£
	To Warehouse Stock Account .		7,200	4,000		By Stock Account		9,000	5,000
	,, Stock Adjustment Account .		1,800	1,000					
			£9,000	£5,000				£9,000	£5,000

Dr. GENERAL EXPENSES *Cr.*

			W.	H.O.				W.	H.O.
			£	£				£	£
	To Bank .		1,800	900		By H.O. Expenses Account .		1,440	
	,, ,, .		420			,, Branch Expenses Account .		800	
	,, Profit and Loss Account		20			,, Profit and Loss Account .			900
			£2,240	£900				£2,240	£900

Dr. TRANSPORT TRADING **Cr.**

		£			£
To Cost per Creditors Account		620	By Head Office Expenses		440
,, Profit and Loss Account: Transport Profit		73	,, Branch Expenses		253
		£693			£693

Dr. WAREHOUSE STOCK **Cr.**

		£			£
To *Balance*	b/d	*3,000*	By Goods sent to Branches Account—		
,, Purchases		11,200	Head Office		7,200
			Branch		4,000
			,, Balance	c/d	3,000
		£14,200			£14,200
To Balance	b/d	3,000			

Dr. STOCK **Cr.**

		H.O.	Branch			H.O.	Branch
		£	£			£	£
To *Balances*	b/d	*2,000*	*1,000*	By Sales—			
,, Goods sent to Branches Account		9,000	5,000	Cash		1,900	600
				Credit		9,000	4,800
				,, Stock Shortage Account			120
				,, Stock	c/d	100	480
		£11,000	£6,000			£11,000	£6,000
To Stock	b/d	100	480				

Dr. STOCK ADJUSTMENT ACCOUNTS **Cr.**

		H.O.	Branch			H.O.	Branch
		£	£			£	£
To Profit and Loss Account		2,180	1,080	By *Balances*	b/d	*400*	*200*
,, Stock Shortage Account			24	,, Goods Sent to Branches Account		1,800	1,000
,, Balances	c/d	20	96				
		£2,200	£1,200			£2,200	£1,200
				By Balances	b/d	20	96

Dr. CREDITORS (TRADE) **Cr.**

		£			£
To Bank		8,000	By *Balances*	b/d	*5,200*
,, Balances	c/d	8,400	,, Purchases		11,200
		£16,400			£16,400
			By Balances	b/d	8,400

Dr. CREDITORS (TRANSPORT) **Cr.**

		£			£
To Bank		700	By *Balances*	b/d	*200*
,, Balances	c/d	120	,, Transport Trading Account		620
		£820			£820
			By Balances	b/d	120

Dr. **Petty Cash** *Cr.*

			H.O.	Branch				H.O.	Branch
	To *Balances*	b/d	£ *140*	£ *60*					

Dr. **Sundry Expenses** *Cr.*

			H.O.	Branch				H.O.	Branch
			£	£				£	£
	To Cash		1,210	470		By Profit and Loss Account		3,090	1,523
	,, Transport[1]		440	253					
	,, Warehouse[1]		1,440	800					
			£3,090	£1,523				£3,090	£1,523

[Expenses grouped under one head for convenience.]

Dr. **Stock Shortage Account** *Cr.*

			£				£
	To Branch Stock Account		120		By Profit and Loss Account		96
					,, Stock Adjustment Account		24
			£120				£120

[Opening balances are in italics.]

Profit and Loss Account for the Year ended 31st December, 19..

Dr. *Cr.*

			H.O	Branch				H.O.	Branch
			£	£				£	£
	To Sundry Expenses		3,090	1,523		By Gross Profit		2,180	1,080
	,, General Expenses		900			,, Loss	c/d	1,810	539
	,, Stock Shortage			96					
			£3,990	£1,619				£3,990	£1,619
	To Loss—	b/d				By Profit on Transport[1]			73
	H O		1,810			,, Over-allocation of Handling Charges[1]			20
	Branch		539	2,349		,, Balance—Net Loss to Capital Account			2,256
				£2 349					£2,349

The above gross profit may be shown in Memorandum Trading Account form as follows.

[1] See notes on page 441.

Memorandum Trading Account

Dr for the Year ended 31st December, 19.. *Cr*

	H O	Branch		H O	Branch
	£	£		£	£
To Stock	1,600	800	By Sales	10,900	5,400
,, Purchases	7,200	4,000	,, Stock	80	384
,, Gross Profit	2,180	1,080	,, Stock Shortage		96
	£10,980	£5 880		£10,980	£5,880

Balance Sheet as at 31st December, 19..

	£	£		£	£
Current Liabilities			Fixed Assets—		
Creditors—			Sundry—Warehouse	1,500	
Trade	8,400		Head Office	3,500	
Transport	120		Branch	1,000	
		8,520			6,000
Capital—			Current Assets—		
Balance—1st January, 19	10,000		Stock—Warehouse	3,000	
Less net Loss	2,256		Head Office	80	
		7,744	Branch	384	
					3,464
			Debtors—Head Office	2,800	
			Branch	1,600	
					4,400
			Bank		2,200
			Petty Cash—Head Office	140	
			Branch	60	
					200
		£16,264			£16,264

Notes—

(1) The Stock in the Balance Sheet is shown at cost, and will be the difference between the Stock at selling price and the Stock Adjustment Account, i e —

	H O	Branch
	£	£
Stock	100	480
Less Stock Adjustment Account .	20	96
	£80	£384

(2) The handling charges are £2,220 as shown in General Expenses, but the "load" to Head Office and Branch is 20 per cent of the cost price of the goods, i e —

	£
20% of £7,200 to Head Office . .	1,440
20% of £4,000 to Branch	800
	£2,240

There is, therefore, an over-allocation of £20

(3) The profit on transport is made up of—

		£
(*a*)	10% of £400 [i e $\frac{10}{11}$ × £440] charged to Head Office .	40
(*b*)	Profit on £220 charged to Branch [i e £253 − £220]	33
(*c*)	I e cost of £620 charged out at £693	£73

(4) The true loss on stock shortage is $\frac{100}{125}$ of £120 = £96

WHERE THE BRANCH HAS FULL SYSTEM OF DOUBLE ENTRY

Each branch will maintain a separate set of double entry books, the connection between the branches and the head office book-keeping system being maintained by means of—

(1) A Branch Account in the head office books.
(2) A Head Office Account in the branch books.

The Head Office Account in the branch books will be analogous to the Capital Account of an ordinary business, the balance usually being on the credit side.

The branch is considered as a definite accounting unit, the results of whose operations will be disclosed by a Branch Profit and Loss Account and Balance Sheet drawn up on ordinary principles.

The first entries made in the branch books will usually be the purchase of certain fixed assets, e.g. shop counters and shelves, with money supplied by the head office. Upon receipt of the cash from the head office, cash will be debited and Head Office Account credited, and when the assets are purchased the Asset Accounts will be debited and cash (or creditors) credited. In the head office books the entries will be a debit to Branch Account and a credit to cash for the money remitted, no cognizance being taken of how such cash is expended by the branch.

Upon the dispatch of goods by the head office to the branch (the goods usually being invoiced at cost price plus a small charge for handling, etc.), in the head office books Goods Sent to Branches Account will be credited and the Branch Account debited with the invoiced price of the goods. In the branch books, Purchases Account will be debited and Head Office Account credited. Returns of goods will be treated in exactly the reverse way, viz.: in the head office books the Goods Sent to Branches Account will be debited and Branch Account credited; and in the branch books the Head Office Account will be debited and Purchases or Purchases Returns Account credited. In the head office books the Goods Sent to Branches Account will be closed off at the end of the accounting period by a transfer to the credit of Purchases or Trading Account; though strictly the small loading in respect of handling should be credited to the account recording the handling expenses and the balance only transferred to Purchases Account. Remittances *by* the branch to the head office in the books of the latter will be debited to the Cash Account and credited to the Branch Account; in the books of the branch such remittances will be debited to the Head Office Account and credited to the Cash Account.

The reverse procedure is necessary for remittances *to* the branch by the head office.

All the purchases and sales of the branch from, and to, outside persons will be dealt with in the ordinary way in the books of the branch. At the end of the accounting period the branch will prepare

its own Profit and Loss Account and Balance Sheet, and if a profit is made it will be transferred to the credit of Head Office Account, and if a loss to the debit of Head Office Account. A copy of the Branch Trial Balance, Profit and Loss Account and Balance Sheet, if such are prepared at the branch, will be sent to the head office. In the head office books, if a profit has been made, Branch Account will be debited and Branch Profit and Loss Account credited. If a loss has been made, Branch Account will be credited and Branch Profit and Loss Account debited. When the trading results of all the branches have been obtained, the balance on Branch Profit and Loss Account will be transferred to the ordinary Profit and Loss Account. It can now be seen that the Branch Account in the head office books and the Head Office Account in the branch books will normally be in contraposition, i.e. they will show the same balance but on opposite sides, the balance on the Head Office Account in the branch books representing the net amount of assets that the branch possesses. Accordingly, when the head office prepares its Balance Sheet, the branch will appear often as a single account, as either a debtor or a creditor. But instead of showing the balance of the Branch Account as *one* item in the Head Office Balance Sheet, the detailed assets and liabilities of the branch comprising such balance may be substituted therefor.

The following illustration incorporates all the above features.

Illustration. A, a London merchant, has a branch in Manchester which trades on its own account. The following is a condensed summary of the transactions of the branch for the year to 31st December, 19. . .

	£
Purchases from Head Office	16,000
Purchases from outsiders—Credit	13,500
Cash	4,500
Sales—Credit	33,000
Cash	27,000
Cash received from Debtors	28,000
Cash paid to Creditors	9,500
Expenses paid by Branch	10,000
,, ,, ,, Head Office for Branch	3,000
Assets purchased at commencement of year	1,000
Cash received from Head Office	2,000
Cash remitted to Head Office	28,000

The branch prepares its own final accounts. Write off depreciation at 10 per cent per annum. Stock on hand at 31st December, 19. ., £6,000. Show Ledger Accounts in the Branch books.

The Ledger Accounts of the branch are—

Dr. HEAD OFFICE *Cr.*

			£				£
	To Cash		28,000		By Cash		2,000
	,, Balance	c/d	11,900		,, Goods		16,000
					,, Cash for Expenses		3,000
					,, Net Profit for Year		18,900
			£39,900				£39,900
					By Balance	b/d	11,900

Dr. **PURCHASES** *Cr.*

		£			£
To Head Office . .		16,000	By Trading Account .		34,000
,, Sundry Creditors .		13,500			
,, Cash . . .		4,500			
		£34,000			£34,000

Dr. **SALES** *Cr.*

		£			£
To Trading Account .		60,000	By Sundry Debtors .		33,000
			,, Cash . . .		27,000
		£60,000			£60,000

Dr. **SUNDRY CREDITORS** *Cr.*

		£			£
To Cash . . .		9,500	By Purchases . .		13,500
,, Balances . .	c/d	4,000			
		£13,500			£13,500
			By Balances . .	b/d	4,000

Dr. **SUNDRY DEBTORS** *Cr.*

		£			£
To Sales . . .		33,000	By Cash . . .		28,000
			, Balances . .	c/d	5,000
		£33,000			£33,000
To Balances . .	b/d	5,000			

Dr. **EXPENSES** *Cr.*

		£			£
To Cash . . .		10,000	By Profit and Loss Account . .		13,000
,, Head Office . .		3,000			
		£13,000			£13,000

Dr. **SUNDRY ASSETS** *Cr.*

		£			£
To Cash . . .		1,000	By Profit and Loss Account: Depreciation . .		100
			,, Balances . .	c/d	900
		£1,000			£1,000
To Balances . .	b/d	900			

Dr. **CASH** *Cr.*

		£			£
To Head Office . .		2,000	By Sundry Assets .		1,000
,, Sundry Debtors .		28,000	,, Head Office . .		28,000
,, Sales . . .		27,000	,, Expenses . .		10,000
			,, Sundry Creditors .		9,500
			,, Purchases . .		4,500
			,, Balance . .	c/d	4,000
		£57,000			£57,000
To Balance. . .	b/d	4,000			

Dr		Stock			Cr.
To Trading Account		£ 6,000			

Branch Trading and Profit and Loss Account for the Year ended 31st December, 19..

Dr.		£	Cr.		£
To Purchases		34,000	By Sales		60,000
" Gross Profit	c/d	32,000	" Stock		6,000
		£66,000			£66,000
To Expenses		13,000	By Gross Profit	b/d	32,000
" Depreciation		100			
" Net Profit to Head Office Account		18,900			
		£32,000			£32,000

Branch Balance Sheet, as at 31st December, 19..

	£			£
Head Office	11,900	Cash		4,000
Sundry Creditors	4,000	Sundry Debtors		5,000
		Stock		6,000
		Sundry Assets	£1,000	
		Less Depreciation	100	
				900
	£15,900			£15,900

Notes. The branch having no opening stock appears to be a new one, in which event the head office will have probably remitted an initial sum to set it going

The detailed accounts would actually be opened in the usual way, e.g. Debtors, Expenses

The Profit and Loss Account and Balance Sheet will be supplied to the head office, or the ordinary Trial Balance with details of stock and adjustments. In the latter case, the head office prepares the final accounts of the branch. The final accounts must be closed off in the books of the *branch*, the usual entries being made, except that the balance of profit or loss of the branch is (in the branch books) transferred to Head Office Account, being the equivalent of a Capital Account for book-keeping purposes.

From the above information, the head office incorporates the results only of the branch operations through the instrumentality of the Branch Account in the head office books. The branch accounts themselves are *not* incorporated in the head office books, as they belong to an entirely self-contained separate system of accounting. This point is important because students are apt to think because combined presentation of the Profit and Loss Account and Balance Sheet is possible, that these details appear in the head office books as part of the double entry. This is not so. The combination above-mentioned is simple and will be noticed presently, but the real connecting link is the reconciliation of the Branch Account in the head office books with the Head Office Account in the branch books.

Hence, mistakes and abnormal circumstances apart, the entries in the head office books are such as to incorporate the results of the branch operations through the medium of the Branch Account. In the head office books, the closing entries are, normally, those relating to profit and loss of the branch. These are—

(1) Debit Branch Account (with branch profit). Credit Profit and Loss Account.

(2) Debit Profit and Loss Account. Credit Branch Account (with branch loss).

These entries (whether a profit or a loss) are opposite to those which the branch makes in its books under the heading of Head Office Account, to which, as has been seen, it transfers its profit or loss. The result is that the two accounts will agree (on *opposite* sides), that is, if the Head Office Account in the branch books is in debit, the Branch Account in the head office books will be in credit; and conversely.

So far as the head office books are concerned, the balance of the Branch Account (as adjusted) will appear as a DEBTOR or a CREDITOR, and that completes the entries.

If the combined accounts are shown they are the results of *two* (or more) distinct and separate sets of books, but as there will be in each set a reciprocal account (Head Office Account in branch; Branch Account in head office), the amounts thereof will connect and consequently be eliminated from the combined figures. But it must be remembered that when two (or more) separate Balance Sheets are combined, the details of the Branch Balance Sheet do not appear in the head office books, the latter recording only the Branch Account as outlined above. This will receive consideration shortly, the matter being referred to at this stage to impress the fact upon the student's mind that the book-keeping entries in the head office are simple, merely involving one transfer, leaving the branch a debtor or creditor.

The entries may now be made in the head office books. These will be, being a branch profit—

Debit Branch Account, £18,900. Credit Profit and Loss Account, £18,900.

The account of the branch in the head office books will thus be—

Dr. BRANCH *Cr.*

			£				£
	To Cash		2,000		By Cash		28,000
	,, Goods		16,000		,, Balance	c/d	11,900
	,, Cash for Expenses		3,000				
	,, Profit and Loss Account. Branch Net Profit for Year		18,900[1]				
			£39,900				£39,900
	To Balance	b/d	11,900[2]				

[1] Ascertained from the figures sent by branch (and as shown in branch books).

[2] This account agrees with that of the Head Office Account in the branch (see page 443), and will appear in the Head Office Balance Sheet as an asset.

After these entries have been made the head office will normally proceed to prepare its own final accounts.

It is usual to have, in the head office books, two separate accounts for each branch, viz. (1) Branch Capital Account, to record the capital invested in the branch; and (2) Branch Current Account, to record the transfers of goods, ordinary remittances to and from the branch, and profit and loss of the branch.

Obviously, in the branch books there will be two separate accounts for the head office: (1) Head Office Capital Account and (2) Head Office Current Account.

On the same principle, remittances may be recorded in a separate account.

Inter-Branch Transfers. The entries required for transfers between branches are: Debit receiving branch, credit Purchases or Sales Account in the sending branch books; and in the receiving branch books, debit Purchases and credit sending branch at either cost or selling price, as the case may be. Alternatively, the entries may be made through the medium of the head office, thus—

Debit Head Office	Credit Purchases or Sales Account (in the sending branch books)
Debit Purchases	Credit Head Office (in the receiving branch books)
Debit Receiving Branch	Credit Sending Branch (in the head office books)

It must be understood thoroughly that inter-branch transfers at selling price, whilst showing a profit to the sending branch, cannot be a true profit of the organization as a whole until a sale by the receiving branch has been made, so that a provision for profit on unsold stock must be created at the time when accounts are prepared. This principle is dealt with on page 452. (See also Chapter XXXII.)

Illustration. "A" Branch transfers goods to "B" Branch at selling price of £200, all transfers being effected through the head office.

The entries are—

"A" Branch books—			
Debit Head Office	£200	Credit Sales.	£200
"B" Branch books—			
Debit Purchases	£200	Credit Head Office.	£200
Head Office books—			
Debit "B" Branch	£200	Credit "A" Branch.	£200

A very common procedure, as has been seen, is to open for current transactions a separate account, designated Current Account, so that the above-mentioned transfers would be posted to the accounts named under the heading of Current Account, e.g. in "A" branch books, debit Head Office Current Account, credit Sales.

Adjustments and Reconciliation of Branch and Head Office Accounts. When occasion requires, e.g. preparation of final accounts (or even interim accounts), any difference in the reflective accounts must be ascertained and either adjusted or corrected.

It is not very difficult to see that the disagreement on any one date between the two accounts may arise from ordinary and normal causes, e.g. cash in transit; goods in transit; receipt of debt due to branch, notification of which has not reached the branch; bill drawn by branch on head office not yet to hand, and so on.

The general principle is to reconcile the *incomplete* account to the *complete* account, and as has been seen, the accounts being reciprocal, the necessary entry must appear on the opposite side in the Head Office Account in the branch books to that in the Branch Account in the head office books, and vice versa.

Illustration. At 31st December, 19.., the head office books contain the following account—

Dr. BRANCH *Cr.*

19..			£	19..			£
Jan. 1	To Balance	b/d	1,500	Dec. 31	By Remittances		800
Dec. 31	" Goods		1,100		" Returns		94
					" Bills Receivable Account		200
					" Balance	c/d	1,506
			£2,600				£2,600
19..							
Jan. 1	To Balance	b/d	1,506				

The account of the head office in the branch books is—

Dr. HEAD OFFICE *Cr.*

19..			£	19..			£
Dec. 31	To Remittances		830	Jan. 1	By Balance	b/d	1,500
	" Returns		120	Dec. 31	" Goods		1,060
	" Balance	c/d	1,610				
			£2,560				£2,560
				19..			
				Jan. 1	By Balance	b/d	1,610

It is ascertained that a remittance of £30 and returns of £26 *from* branch to head office are in transit; whilst an amount of £40 goods *from* head office to branch is in transit. A Bill of Exchange of £200 drawn by the head office on the branch had not reached the branch on 31st December.

Proceeding on the rule to reconcile the *incomplete* to the *complete*, the items of £30 and £26 dealt with by branch but not by head office, must be brought into the latter's books. Thus—

Debit Cash in Transit . £30	Credit Branch (*a*). £30	in Head Office books
Debit Stock in Transit. £26	Credit Branch (*b*). £26	

Following the same rule, the items of £40 and £200 must be introduced into the branch books.

Debit Head Office (*c*) . £200	Credit Bills Payable . £200	in Branch books
Debit Stock in transit. £40	Credit Head Office (*d*). £40	

The accounts will now be—

Dr. (1) BRANCH ACCOUNT (IN HEAD OFFICE BOOKS) *Cr.*

			£				£
	To Balance (as above)	b/d	1,506		By Cash in Transit	(*a*)	30
					,, Stock in Transit	(*b*)	26
					,, Balance	c/d	1,450
			£1,506				£1,506
	To Balance	b/d	1,450				

Dr. (2) HEAD OFFICE ACCOUNT (IN BRANCH BOOKS) *Cr.*

			£				£
	To Bill Payable	(*c*)	200		By Balance (as above)	b/d	1,610
	,, Balance	c/d	1,450		,, Stock in Transit	(*d*)	40
			£1,650				£1,650
					By Balance	b/d	1,450

The other items will be posted to the respective accounts.

Alternatively, it may be more convenient to treat as correct the Head Office Account in the branch (save for the transfer required in respect of profit or loss of branch), in which case the adjustments necessary will be made in the head office books to arrive at the branch figure of £1,610, thus—

Debit	Cash in Transit	£30	Credit Branch	£96
	Stock in Transit	£26		
	Stock in Transit	£40		
Debit	Branch	£200	Credit Bills Receivable.	£200

The Branch Account in the head office will now be—

Dr. BRANCH *Cr.*

			£				£
	To Balance	b/d	1,506		By Sundries (as above)		96
	,, Bills Receivable.		200		,, Balance	c/d	1,610
			£1,706				£1,706
	To Balance	b/d	1,610				

The first method reflects the true position; the second does not, as it cancels entries omitted in one set of books, instead of introducing them into the books which ought to have included them. (It will be remembered that in Bank Reconciliation Accounts the same point arises, viz. first to correct omissions in the Cash Book and then work from the Bank Pass Book balance to the Cash Book balance.)

In the succeeding period, using the second method, the items adjusted above would be re-transferred, e.g. in the head office books the Bill Receivable would be re-debited and credited to the Branch Account, whilst in due course the branch on acceptance of the bill would debit head office and credit Bills Payable.

In the first method these entries in the head office books would not be necessary, as the bill already appears in the proper account.

When the cash (which at the date of the Balance Sheet is in transit) is received from the branch, it must be credited to cash in transit, and not to branch, as the latter account has already been credited. The same principle applies to stock in transit.

Illustration. The following account is in the head office books—

Dr. BRANCH *Cr.*

			£				£
	To Balance . . .	b/d	2,400				

In the branch books—

Dr. HEAD OFFICE *Cr.*

			£				£
					By Balance . . .	b/d	2,300

The difference arises by reason of a remittance of £100 by the branch, not yet to hand.

Using the first method, the entries required in the head office books are: debit Cash in Transit Account, £100; credit Branch Account, £100. This reconciles the account with the balance of £2,300 in the branch. When (normally in the course of a few days) the cash is received, the entries will be: debit Cash, £100; credit Cash in Transit Account, £100.[1]

It may be noted that where there are numerous adjustments the whole of them may be brought down into one account, e.g. Suspense Account, instead of in separate accounts, e.g. Cash in Transit, Stock in Transit, etc., in which case the postings in the new period will be made to the one account.

Illustration. Head office makes its accounts up to 31st December. Branch Account is in debit for £4,000. The accounts as rendered by the branch show the head office to be in credit for £3,600, the difference being accounted for by the following entries, which appear in the branch books only.

			£
Dec. 26.	(1)	Goods returned to Head Office . .	200
30.	(2)	Cash sent to Head Office . . .	450
31.	(3)	Proceeds of Bill collected for Head Office	250

The Branch Account in the head office books will be—

Dr. BRANCH *Cr.*

			£				£
	To Balance . .	b/d	4,000		By Suspense Account—		
	„ Suspense Account— Cash Collected .		250		Goods in Transit .		200
					Cash in Transit .		450
					„ Balance . .	c/d	3,600
			£4,250				£4,250
	To Balance . . .	b/d	3,600				

[1] Alternatively the first entries may be reversed in the new period, bringing the account back to £2,400, in which case £100 is credited to Branch Account upon receipt of cash.

Dr. SUSPENSE *Cr.*

			£				£
	To Branch Account—				By Branch Account—		
	Goods in Transit		200		Cash Collected [1]		250
	Cash in Transit		450		,, Balance	c/d	400
			£650				£650
	To Balance	b/d	400				

General Illustration. The Universal Providers Co. have one branch which draws its supplies chiefly from its head office and partly from outside suppliers. The goods sent from head office are invoiced at cost plus 25 per cent.

The Head Office Trial Balance is—

TRIAL BALANCE, 31ST DECEMBER, 19..	*Dr.*	*Cr.*
	£	£
Capital		20,000
Sundry Fixed Assets	10,600	
Stock	9,000	
Debtors	10,400	
Creditors		9,000
Cash at Bank	1,350	
Purchases	80,000	
Sales		92,000
Sundry Expenses	10,000	
Goods invoiced to Branch at Selling Price		8,000
Goods returned from Branch at Selling Price	450	
Branch Capital Account	6,000	
Branch Current Account	1,200	
	£129,000	£129,000

Closing Stock—
£7,500, Head Office.
£1,900, Branch [Head Office Goods, £650], exclusive of Stock of £350 in transit from Head Office to branch.

From the above and the following figures prepare a combined Trading and Profit and Loss Account for the year ended 31st December, 19.., and Balance Sheet at that date. Make the adjustments for "transit" items in the head office books.

	£
Branch details—	
Debtors	900
Creditors	1,100
Sales	13,650
Purchases (from outsiders)	4,500
Stock ("outside" Goods)	1,250
Sundry Fixed Assets	5,400
Sundry Expenses	1,500
Cash at Bank (after deduction of £100 Cash in transit from Branch to Head Office)	750
Depreciation—	
Head Office Fixed Assets	310
Branch Fixed Assets	165

[1] Alternatively this may be credited to the account which is in debit, e.g. Bills Receivable or Debtor.

Before proceeding with the illustration the student should at once observe that as the branch keeps separate accounts, balances of the latter must be completed by the introduction of the stock received from and returned to the head office, and that the question involves the treatment of cash, stock in transit, and the elimination of profit on unsold stock.

In the books, the accounts of the branch will be closed off in the usual way, the balance of profit or loss being transferred to head office. The books of the latter will be closed off in the usual way after incorporating the branch results, and reconciling the Branch Account and eliminating profit on unsold stock.

The question, however, does not require the ACTUAL entries in the books, so the student must be prepared to proceed directly to the ultimate results without recording entries in the books.

The Trial Balance of the branch will be placed side by side with that of the head office, after which the inflated price of goods transferred will be reduced in both books (on opposite sides), which will still preserve the agreement of the collective balances.

TRIAL BALANCES, 31ST DECEMBER, 19..

	Head Office		Branch	
	Dr. £	Cr. £	Dr. £	Cr. £
Capital		20,000		
Sundry Fixed Assets	10,600		5,400	
Stock	9,000		1,250	
Debtors	10,400		900	
Creditors		9,000		1,100
Cash at Bank	1,350		750	
Purchases	80,000		4,500	
Sales		92,000		13,650
Sundry Expenses	10,000		1,500	
Internal Transfers of Goods		8,000	*7,650*	
Internal Transfers of Goods (Returns)	450			*450*
Branch Capital	6,000			*6,000*
Branch Current Account	750			*750*
Cash in Transit	100			
Goods in Transit	350			
	£129,000	£129,000	£21,950	£21,950

Depreciation of fixed assets: Head Office, £310; Branch, £165.

The items in italics are omitted in the question. The £100 represents cash in transit, and this will probably have been debited to head office, reducing the balance on credit of Head Office Current Account; but it is shown separately, as it must be featured separately. The reconciliation is made in head office books, but it is immaterial for the purpose of obtaining the final accounts in which set of books the reconciliation is made.

Dr. COMBINED TRADING AND PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 19.. *Cr.*

	Branch	Head Office	Total		Branch	Head Office	Total
	£	£	£		£	£	£
To Stock	1,250	9,000	10,250	By Sales	13,650	92,000	105,650
,, Purchases	4,500	80,000	84,500	,, Transfers (at cost) *contra*	360	6,120	
,, Transfers (at cost) *contra*	6,120	360		,, Stock in Transit (at cost)		280	280
,, Gross Profit c/d	3,910	16,540	20,450	,, Stock (at cost)	1,770	7,500	9,270
	£15,780	£105,900	£115,200		£15,780	£105,900	£115,200
To Sundry Expenses	1,500	10,000	11,500	By Gross Profit b/d	3,910	16,540	20,450
,, Depreciation	165	310	475				
,, Net Profit	2,245	6,230	8,475				
	£3,910	£16,540	£20,450		£3,910	£16,540	£20,450

As to stock in transit, this has been entered in the head office books only, so that there will be a separate account for stock in transit of £350, the amount thereof having been included in the goods sent to branches.

The adjusted items may now be brought down to cost, and as the reduction will be equally effective on opposite sides of each Trial Balance, it will not disturb the total agreement. The final accounts may now be prepared. (The Combined Trading and Profit and Loss Account appears on page 453.)

COMBINED BALANCE SHEET AS AT 31ST DECEMBER, 19 .

	£	£			£	£
Capital		20,000	Fixed Assets—			
Profit and Loss Account		8,475	Sundry (*less* Depreciation)—			
			Head Office		10,290	
		28,475	Branch		5,235	
Current Liabilities—						15,525
Creditors—			Current Assets—			
Head Office	9,000		Stock—	£		
Branch	1,100		Head Office	7,500		
		10,100	Branch	1,770		
			Transit	280		
					9,550	
			Debtors—			
			Head Office	10,400		
			Branch	900		
					11,300	
			Cash at Bank—			
			Head Office	1,350		
			Branch	750		
			Transit	100		
					2,200	
						23,050
		£38,575				£38,575

Notes—

(1) Goods £7,650, being at selling price, must be reduced by 20%, i.e. £1,530, leaving the figures per Trading Account at £6,120.

(2) Similarly, the returns of £450 must be reduced by 20%, leaving £360.

(3) The Stock of Head Office goods at selling price is £650 as given in question, at cost is £650 less 20%, i.e. £130 = £520: to this must be added the remainder of the goods (i.e. outside purchases) of £1,250, the total, therefore, being £1,770.

(4) The goods in transit must be brought in at cost [viz. £350 less 20%, i.e. £70 = £280].

FOREIGN BRANCHES

There are no special book-keeping methods employed in recording the transactions of foreign branches, the only distinctive feature being the treatment of the foreign exchange. If foreign branches are considered to be in the nature of a foreign investment, no difficulty will be encountered. The head office, if in a sterling country, will keep its accounts in sterling, and the branch will keep its accounts in foreign currency. The branch will open a Head Office Account in its books to record all transactions with the head office; the head office recording these transactions in a Branch Account. There are three methods of converting branch transactions in foreign currency into sterling, and *vice versa*—

(1) To convert all transactions at a certain fixed rate (e.g. the

official rate at a certain date or at the beginning of the accounting period). Where the exchange is comparatively stable there will be a small difference to transfer to a Profit and Loss on Exchange Account at the end of each accounting period.

(2) Where the exchange fluctuates widely, an artificial parity is sometimes assumed as in (1), with periodic adjustments in the books.

(3) Where the exchange fluctuates within comparatively narrow limits, the usual procedure is to allow the head office and branch books to be kept independently, and at the end of the accounting period each item in the Trial Balance or Balance Sheet forwarded by the branch will be converted at certain rates relative to the nature of each item.

The various methods will now be dealt with in detail—

(1) and (2) Stable Exchanges and Violently Fluctuating Exchanges. The method adopted is to enter in each set of books the actual receipts or payments incurred, which will be converted at the fixed rate. At the end of the accounting period the head office will value its "investment" in foreign currency at the fixed rate, and the difference between such value and the balance of the account in foreign currency will be transferred to Exchange Reserve Account. This balance will equal the figures as to both foreign currency and sterling in the branch books. The reserve merely serves to maintain the figures at the fixed rate of exchange, and does not bring the valuation of the foreign currency to the TRUE rate of exchange unless special provision is made separately therefor.

Illustration. A concern in London has a foreign branch. Transactions are recorded as between the head office and the branch at \$5 to £. During the year to 31st December, the following transactions arise between the head office and the branch—

Sterling bought by Branch and remitted to London, £2,004 cost \$10,000.
Sterling bought by Branch and remitted to London, £2,000 cost \$ 9,840
Dollars bought in London and remitted to Branch, \$5,000 cost £970.
Dollars bought in London and remitted to Branch, \$1,040 cost £200.

Write up the Branch and London books.

BRANCH BOOKS—

Dr. HEAD OFFICE *Cr.*

		£	\$			£	\$
To Cash		2,000	10,000	By Cash		1,000	5,000
" "		1,968	9,840	" "		208	1,040
				" Balance	c/d	2,760	13,800
		£3,968	\$19,840			£3,968	\$19,840
To Balance	b/d	2,760	13,800				

LONDON BOOKS—

Dr. BRANCH *Cr.*

		\$	£			\$	£
To Cash		4,850	970	By Cash		10,020	2,004
" "		1,000	200	" "		10,000	2,000
" Exchange Reserve		370	74				
" Balance	c/d	13,800	2,760				
		\$20,020	£4,004			\$20,020	£4,004
				By Balance	b/d	13,800	2,760

Dr. EXCHANGE RESERVE Cr.

						By Branch . . .		$ 870	£ 74

Stores Accounts. When branches are situated in countries having a violently fluctuating rate of exchange, it is customary to transfer all capital expenditure to head office as and when it is incurred in order that a permanent record of the asset shall be kept in a non-fluctuating exchange. In order that the results shown by the books concerned should be reflective of the true position, it is equally important that a sound basis be used to eliminate the exchange fluctuations from Stores Account (which appears in the branch books).

Illustration. During January, 19.., a head office consigns stores to its foreign branch of a sterling equivalent of £1,000, the rate of exchange being $10 = £1. Fluctuations in this example are ignored. The entries in the branch books will be—

Dr. HEAD OFFICE Cr.

					19.. Jan. 31	By Stores . .		$ 10,000	£ 1,000

Dr. STORES Cr.

19.. Jan. 31	To Head Office .		$ 10,000						

It is now assumed that half of these stores are used on Capital Account during the month of February, 19.., when the rate of exchange is $8 = £1, and that the other half are used on account of revenue during the month of March, when the rate of exchange is $11 = £1.

The entries in journal form will be as follows—

JOURNAL

19..			$	$
Feb. 28	Capital Expenditure . . . . . *Dr.*		5,000	
	To Stores			5,000
Mar. 31	Revenue . . . . . . *Dr.*		5,000	
	To Stores			5,000

The capital expenditure will be transferred to Head Office Account at an average rate of $8 = £1, that is £625, and the Revenue items will be transferred at $11 = £1, that is £455 (approx.). Thus stores costing £1,000 have all been used and charged out at £1,080, which is very unsatisfactory.

In order to obviate this, the following method is adopted. The Stores Account is ruled with double columns, one to record the transactions at a *nominal* rate of exchange, and the other to record them at the *actual* rate at which they take place.

When stores are transferred from head office, Head Office Account is credited and Stores Account debited, and at the same time

an entry is made in the memorandum column on the basis of the rate adopted therein. The transactions in the above example (that is, half the stores are utilized for capital purposes and half for revenue purposes) will first be entered on the credit side in the memorandum column in terms of the nominal standard rate adopted. Using this as a basis, they are then inserted in the other column at the actual rate then ruling.

Illustration. Assume the same facts as in the previous illustration, and that the nominal standard rate adopted is \$20 = £1. The entries will be as follows—

Dr. STORES *Cr.*

			Nominal	Real Value				Nominal	Real Value
19..			\$	\$	19..			\$	\$
Jan. 31	To Head Office		20,000	10,000	Feb. 28	By Capital .		10,000	4,000
					Mar. 31	„ Revenue		10,000	5,500
						„ H.O. Account: Diff. in Exchange			[illegible]00
			\$20,000	\$10,000				\$20,000	\$10,000

Dr. HEAD OFFICE *Cr.*

		\$	£			\$	£
19..				19..			
Feb. 28	To Capital Expenditure Account .	4,000	500	Jan. 31	By Stores . .	10,000	1,000
Mar. 31	„ Revenue Account .	5,500	500				
	„ Difference in Exchange .	500					
		\$10,000	£1,000			\$10,000	£1,000

Dr. REVENUE ACCOUNT *Cr.*

			\$				\$
19.. Mar. 31	To Stores . . .		5,500	19.. Mar. 31	By Head Office		5,500

Dr. CAPITAL EXPENDITURE ACCOUNT *Cr.*

			\$				\$
19.. Feb. 28	To Stores . . .		4,000	19.. Feb. 28	By Head Office . .		4,000

It will be seen from the above that each item now bears its appropriate sterling equivalent of the total stores consumed. The Stores Account is closed off by transferring the difference on exchange to the Head Office Account, inserting the figure in the dollar column only.

If, at the end of the accounting period, there are certain stores on hand, the procedure in bringing down the balance is briefly described as follows—

The amount of stores in terms of foreign currency at the nominal or *standard* rate is inserted in the nominal column; its equivalent is then entered in the real column, having regard to the current rate of exchange. Any difference is transferred to the Head Office Account (foreign currency column only).

The following example illustrates all the principles involved.

Illustration. A foreign branch, situated in a country having a fluctuating dollar currency, has the following transactions with the London head office during July, 19...

Stores received from London ($15 = £1)	£3,000
Stores purchased locally	$10,000
Stores used on Capital (standard rate)	$5,000
Stores used on Revenue (standard rate)	$30,000
Sales (all cash)	$60,000
Wages (Capital)	$5,000
Wages (Revenue)	$12,000

During the month $20,000 were remitted to head office at an **actual** rate of $12·50 = £1; **standard** rate $20 = £1.

Average rate for the month, $10 = £1. Rate on the 31st July, $8 = £1. Show entries in branch books.

Dr. STORES *Cr.*

		Rate	Nominal Value	Real Value			Rate	Nominal Value	Real Value
19..			$	$	19..			$	$
July 31	To Head Office	15	60,000	45,000	July 31	By Capital Expenditure (2)	10	5,000	2,500
	„ Cash (1)	10	20,000	10,000		„ Revenue Account	10	30,000	15,000
						„ Head Office—DIFFERENCE IN EXCHANGE			19,500
						„ Balance (3) c/d	8	45,000	18,000
			$80,000	$55,000				$80,000	$55,000
Aug. 1	To Balance b/d	8	45,000	18,000					

Dr. HEAD OFFICE *Cr.*

		Rate	$	£			Rate	$	£
19..					19..				
July 31	To Cash	12·50	20,000	1,600	July 31	By Stores	15	45,000	3,000
	„ Capital	10·00	7,500	750		„ Profit	10	33,000	3,300
	„ Stores—DIFFERENCE IN EXCHANGE		19,500						
	„ Balance	c/d	31,000	3,950					
			$78,000	£6,300				$78,000	£6,300
					Aug. 1	By Balance	b/d	31,000	3,950

Dr. REVENUE ACCOUNT *Cr.*

			$				$
19..				19..			
July 31	To Stores		15,000	July 31	By Sales		60,000
	„ Wages		12,000				
	„ Head Office Account Profit		33,000				
			$60,000				$60,000

Dr. CAPITAL EXPENDITURE *Cr.*

19..		Rate	$	£	19..		Rate	$	£
July 31	To Stores Account .	10	2,500	250	July 31	By Head Office Transfer	10	7,500	750
	,, Wages .	10	5,000	500					
			$7,500	£750				$7,500	£750

Dr. CASH *Cr.*

19..			$	19..			$
July 31	To Sales		60,000	July 31	By Stores . . .		10,000
					,, Head Office . .		20,000
					,, Wages. . .		17,000
					,, Balance . .	c/d	13,000
			$60,000				$60,000
Aug 1	To Balance . . .	b/d	13,000				

BRANCH TRIAL BALANCE, 31ST JULY, 19..

	Rate	*Dr.* £	*Cr.* £	*Dr.* $	*Cr.* $
Stores	8	2,250		*18,000*	
Head Office (per ledger) . .			3,950		*31,000*
Cash at Bank	8	1,625		*13,000*	
Difference in Exchange . . .		75			
		£3,950	£3,950	*$31,000*	*$31,000*

The sterling columns are those used for inclusion in the head office books. It should be noted that as a matter of good financial policy, if the rate is expected to return to, say, \$10 = £1 it will be beneficial to the concern to send all cash from the branch when the rate is at \$8 = £1.

Nominal Value and Its Relation to Real Value. In the foregoing Stores Account, the following points should be noted—

(1) To Cash (i.e. Local Purchases) (Nominal Value) \$20,000, (Real Value) \$10,000

Sterling equivalent of \$10,000 = £1,000 $\left[\frac{10,000}{10}\right]$

Nominal Value of £1,000 = £1,000 × 20 = \$20,000

(2) By Capital Expenditure (Nominal Value) \$5,000, (Real Value) \$2,500

Sterling equivalent of \$2,500 = £250 $\left[\frac{2,500}{10}\right]$

Nominal Value of £250 = £250 × 20 = \$5,000

(3) By Balance (Nominal Value) \$45,000, (Real Value) \$18,000

Sterling equivalent of \$45,000 = £2,250 $\left[\frac{45,000}{20}\right]$

Real Value of £2,250 = £2,250 × 8 = \$18,000

The rule may be formulated as follows—

$$\text{Nominal Value} = \text{Real Value} \times \frac{\text{Standard Rate of Conversion}}{\text{Real Rate of Conversion}}$$

e.g. (1) $\$20,000 = \$10,000 \times \frac{20}{10}$

and conversely—

$$\text{Real Value} = \text{Nominal Value} \times \frac{\text{Real Rate of Conversion}}{\text{Standard Rate of Conversion}}$$

(3) **Moderately Fluctuating Exchange.** Where the rate of exchange fluctuates moderately, the rates of conversion used vary according to circumstances, but the generally accepted rules will be those outlined on pages 463 and 464.

The principles broadly follow those already outlined, the only modification being that the rate of conversion of the branch balance is not uniform; nevertheless, as has been shown, the vital account is the Branch Account in the head office books, which must agree with the Head Office Account in the branch books: but as the one account is in sterling and the other in currency, it is necessary to employ in the Branch Account of the head office an extra column on each side of the Ledger, but not as part of the double entry. By this means the balances of the reciprocal accounts will agree in currency, from which the double entry will be compiled.

Before formally enunciating the rules, a very simple set of circumstances may be imagined from which the whole idea may be assimilated. It will be remembered that the foreign branch will keep its accounts in its native currency, and, as a rule, has no sterling entries contained in its financial books, whether or not the rate of exchange is a stable or erratic one.

Illustration. Let it be assumed that a head office starts a branch in Bulganaland and for that purpose remits £1,000, which produces, at 50 to £, 50,000 bulgans. During the year the foreign branch makes a profit of 10,000 bulgans. No further remittances are made either way. Now it should be quite apparent that in the foreign branch books the final Balance Sheet will be—

BALANCE SHEET

		Bulgans		Bulgans
Head Office . .	50,000		Sundry Assets,	
Plus Profit. .	10,000		(*Less* Liabilities) . .	60,000
		60,000		

The head office has, so to speak, invested £1,000 in a foreign venture so that the entry will be—

Debit Bulganaland Branch, £1,000 Credit Cash, £1,000

As, however, the sum has been converted into another form of currency, it is necessary to have a memorandum column showing

the quantity of foreign currency representing the original investment, just as in the instance of an investor who will show the number of shares or quantity of stock bought; but this, it must be remembered, is NO PART of the DOUBLE ENTRY.

The account of the foreign branch will, at the initial stage, appear thus—

Dr. BULGANALAND BRANCH *Cr.*

		Bulgans	Stg.				
	To Cash.	50,000	£ 1,000				

The account will (in this instance, no further transactions with the branch having taken place) remain dormant until the receipt of necessary details from the branch. It is the next step that causes confusion to students, so that particular attention should be paid thereto.

The memorandum columns should be completed from the entries appearing in the Head Office Account of the branch—on, obviously, the opposite side to those in the branch. No double entry whatever as yet comes into these entries. Continuing the account, it will now appear—

Dr. BULGANALAND BRANCH *Cr.*

		Bulgans	Stg.			*Bulgans*	Stg.
	To Cash.	*50,000*	£ 1,000		By Balance . c/d	*60,000*	£ (2)
	„ Profit and Loss Account	*10,000*	(1)				
		60,000				*60,000*	
	By Balance . b/d	*60,000*					

It will be seen that there is agreement as regards CURRENCY between the two reflective accounts.

The next step is merely to fill up the sterling equivalents and obtain the DOUBLE ENTRY therefrom; that is, gaps represented by (1) and (2) must be filled, and in case of (1) a credit to Profit and Loss Account, and (2) the balance brought down. The general rules for conversion will be fully stated on pages 463 and 464, but it may be stated that usually the profit and loss item is converted at the average rate of exchange obtaining over the year. The closing balance will be valued according to the type of assets and liabilities contained in the Branch Balance Sheet, and in this particular problem the current rate of exchange ruling at the date of taking out the final accounts will be used. These will be assumed (1) average rate at 28 to £; (2) current rate at 31 to £.

The figures arising therefrom (to nearest £) are—

(1) 10,000 @ 28 = $\frac{10,000}{28}$ = £357
(2) 60,000 @ 31 = $\frac{60,000}{31}$ = £1,936

As each set of figures is based upon different rates of exchange, the balance of sterling will be inserted to make the account balance

and to transfer to Profit or Loss on Exchange Account. No entry will be made in the memorandum columns as these exactly agree with the Head Office Account in the branch. The accounts will finally appear—

Dr. BULGANALAND BRANCH *Cr.*

	Bulgans	Stg.		*Bulgans*	Stg.
		£			£
To Cash . .	*60,000*	1,000	By Balance. c/d	*60,000*	1,936
„ Profit and Loss Account .	*10,000*	357			
„ Profit and Loss on Exchange Account .		579			
	60,000	£1,936		*60,000*	£1,936
To Balance. b/d	*60,000*	1,936			

The position is that the original investment was £1,000, augmented by £357, equalling £1,357 (on rates of exchange given), and represented by 60,000 bulgans. At the date of the final accounts these bulgans are more valuable as the rate of exchange has APPRECIATED from 50 to £ to 31 to £, thus giving a very high exchange profit of £579—far higher in fact than the trading profits. It is therefore a simple matter to obtain the double entry once the sterling values have been calculated.

Before proceeding further it may be as well to point out the other side of the picture. Assuming that the "investment" at the date of the final accounts, viz. 60,000, is worth 100 to £, it will be apparent that the value is £600 only, thus bringing about not only a complete cancellation of the profits, but a loss on the capital invested. The account will be (eliminating currency, which will remain constant, whatever may be the rate of exchange)—

Dr. BULGANALAND BRANCH *Cr.*

		£			£
To Cash. . . .		1,000	By Balance . . . [i.e. 60,000 @ 100 to £]	c/d	600
„ Profit and Loss Account . . .		357	„ Loss on Exchange .		757
		£1,357			£1,357
To Balance . . .	b/d	600			

The average rate of 28 in view of the end rate of 100 to £ is unlikely unless, indeed, some catastrophic event has occurred towards the end of the financial year in question, but this in nowise affects the principle. Although the method under review postulates reasonable stability of exchange, extremes have been taken to make the illustrations clear.

To discuss this aspect fully would lead to a protracted and lengthy incursion into economic science, but it may be dismissed by mentioning that with the adverse rate the Bulganaland earnings would tend to rise and so offset a portion of the loss on exchange.

Rules for Conversion of Foreign Currency. The rules for conversion of foreign currency may be stated thus—

Item	*Rate employed for conversion*
(1) Fixed Assets	At the rate ruling either— (1) At the date of contract. (2) At the date of delivery. (3) At the date or dates of payment. (4) At the date of remittance or dates of remittances therefor.

The *same* rate will be used in future years in respect of the fixed assets actually acquired at the commencement of the period, e.g. if fixed assets were acquired in 1932, say 12,000 francs at 120 to £, the amount shown in 1932 and subsequent years, in sterling, will (apart from Depreciation and Sales) be £100.

Item	*Rate employed for conversion*
(2) Fixed Liabilities	At the rate ruling— (1) At the date of contract. (2) At the date incurred.

It must be realized, however, that a liability which is "fixed," that is a *long term* liability, will usually sooner or later become a current liability, so that as the date for repayment approaches, it should, particularly if the rate of exchange has moved adversely, be viewed as a *current* liability.[1] If the liability is undertaken in terms of payment in STERLING, then the commitment is, whatever the rate of exchange, only the same amount of sterling that has been shown in the books throughout the period of the loan, e.g. if 12,000 francs at 120 to £ had been borrowed to be repaid in twenty years' time in STERLING, the liability to be discharged is £100 only; but if the loan had been in terms of francs and the rate had appreciated to 60 to £, the cost of acquiring 12,000 francs would be £200.

Items	*Rate employed for conversion*
(3) Current Assets and Liabilities	At the rate ruling— At the date of the end of the accounting period.
(4) Remittances	The cost of the foreign currency where remittances made *to* branch. The amount produced in sterling where remittance made *from* branch.
(5) Transfer of Goods	At the rate ruling— (1) At the date of dispatch. (2) At the date of receipt. (3) At the date the customer would be debited.

[1] When long-term liabilities are repayable in foreign currency, they are often converted at the year-end rate of exchange so that any probable loss on repayment is shown in each Balance Sheet.

(6) Profit and Loss items	At the average rate ruling over the whole period except for— (a) Depreciation of fixed assets, which will be taken at the rate ruling at acquisition. (b) Opening stock which will have been valued at the end of the preceding accounting period as a current asset. (Rule 3.) (c) Closing stock which will be valued as a current asset at the date of the end of the accounting period. (Rule 3.)[1]

The rule of average rate is one of convenience, but where it is practicable a rate more closely conforming to facts may be employed.

(a) Where the branch opens up new premises during the accounting period, the rent may be taken at the average rate for the period elapsing between the occupation of the premises and the end of the accounting period.

(b) Where there are cross supplies of goods between head office and the branch, the rates ruling at the dates of consignment or arrival may be employed. (See Rule 5.)

(c) Where expenses and sales and purchases are not spread fairly evenly over the accounting period a WEIGHTED average may be employed.

It will be clear that no conversion rate appears for the commencing balances of the reciprocal accounts of Branch Account in the head

[1] It may be objected that by adopting rule 6 (c) a valuation at higher than cost would result if the average rate of exchange (used for the purchases and expenses) were lower than the closing rate. The effect would be to inflate the profit of the Branch by an appreciation in exchange which may quite probably be only temporary; on the other hand, use of the conventional conversion rates is arbitrary, and the conversion into sterling is merely symbolic and does not produce a true sterling result at all.

If, however, the Stock can be identified as that sent out to the Branch on a particular date, the rate of exchange on that date would be equally correct as the basis of conversion; separate identification with varying rates is not, however, usually practicable or possible.

It may even be that some of the closing stock is part of the stock at the commencement of the accounting period, suggesting the probability that it is not readily saleable.

The principles to follow should therefore be—

(1) Stock held at the commencement of the period and still unsold at the end should be converted at the rate taken at the former date.

(2) Stock which is easily identifiable, at the rate of exchange at the date of purchase or transfer.

(3) Otherwise, at the average rate for the accounting period or at the rate ruling at the close of the accounting period.

In all cases the foreign currency equivalent should, if necessary, be reduced to market value before conversion.

The exchange fluctuation element is a factor in every year, and provided (a) that due regard is paid to any depreciated values (without reference to conversion rates), (b) that a uniform method is adopted, and (c) that exchange fluctuations are effected through an Exchange Suspense or Reserve, then the exact method is not material in normal circumstances.

office and Head Office Account in the branch, as at the commencement of the period the amount shown in *sterling* for or against the branch in the head office books *is* the valuation of the branch; whilst the balances between the head office and branch in *currency* are equal.

Alternative methods of conversion are—

(1) To convert only the balance of and not the individual items in the Trading and Profit and Loss Account. Those who employ this method argue that the true profit (or loss) is represented by the increase (or decrease) of net assets during the year, assuming no receipts or expenditure of Capital. Where such receipts or expenditure do take place, the Profit or Loss on Exchange should be brought into account either at the time of the transaction or at the end of the year.

(2) To convert the balance of the Trading and Profit and Loss Account as the balancing item of the Branch Current Account. The resulting sterling value of the Trading and Profit and Loss Account figure, containing as it does the Profit and Loss on Exchange, will be different from that obtained by converting the individual items, but the Balance Sheet will be the same in either method.

Profit and Loss on Exchange. The orthodox treatment is—

(1) If a profit, carry forward against future losses;
(2) If a loss, utilize the reserve of (1), otherwise write off.

If, however, the accounts have been properly drawn up, it can quite reasonably be accepted that a profit (or loss) has actually been earned (or lost), reflected in the Profit and Loss on Exchange balance for the year, particularly as it is not necessary to have turned a profit on paper into cash to be able to consider it as true profit (if it were so, such items as Debtors would have to be turned into cash as a necessary preliminary to obtaining the profit figure).

On the other hand, if it is reasonably certain that a loss on exchange will arise in the next period, proper provision should be made.

If a profit or loss on exchange is attachable to any capital receipt or expenditure, it should be transferred thereto from the Profit and Loss on Exchange Account.

In examinations the candidate is often called upon to prepare draft final accounts direct from the Trial Balance figures without making the actual entries in the books of the concern.

The procedure is—

(1) Prepare the Branch Profit and Loss Account (in currency), unless this has already been done by the branch.

(2) The balance of (1) is shown as a separate item in currency.

(3) The assets and liabilities, placed in debit and credit columns, along with balance of (2), are *converted* into sterling, but as the rates of conversion differ, there will be a difference in the two columns.

This figure is merely inserted as a balance which will, if inserted on the debit, be loss on exchange and, if credit, will be a profit.

(4) Remittance Account will be transferred to the Head Office Account which will agree with the Branch Account in the head office books, ignoring "transit" items.

(5) The assets and liabilities of both the head office and the branch may be combined (eliminating the reciprocal accounts).

A number of illustrations are now appended dealing with the principles outlined.

Illustration. The Branch Trial Balance is—

	Dr.	*Cr.*
	\$	\$
Furniture	4,046	
Debtors	11,281	
Creditors		500
Cash at Bank	14,560	
Profit and Loss Account – Profit for year		3,413
Head Office (£6,862)		32,067
Stock	6,093	
	\$35,980	\$35,980

The Head Office Trial Balance is—

	Dr.	*Cr.*
	£	£
Branch	6,862	
Capital		7,500
Cash at Bank	826	
Profit and Loss Account		188
	£7,688	£7,688

Rate of Exchange at close of accounting period . . . 4·67
Average Exchange over period . . . 4·65
Rate of Exchange at date of purchase of Furniture . . . 4·88

Prepare Balance Sheet.

The question will be worked (1) as usually required for examination purposes; and (2) as required in practice.

(1)

	Rate of Exchange	Branch Trial Balance \$	\$	£	s.	d.	£	s.	d.	Head Office Trial Balance £	£
		Dr.	*Cr.*	*Dr.*			*Cr.*			*Dr.*	*Cr.*
Furniture	4·88	4,046		829	2	0					
Debtors	4·67	11,281		2,415	12	8					
Creditors	4·67		500				107	1	4		
Cash at Bank	4·67	14,560		3,117	15	6				826	
Profit and Loss Account	4·65		3,413				733	19	7		188
Head Office and Branch	—		32,067				6,862	0	0	6,862	
Stock	4·67	6,093		1,304	14	3					
Difference in Exchange				35	16	6					
Capital											7,500
		\$35,980	\$35,980	£7,703	0	11	£7,703	0	11	£7,688	£7,688

BALANCE SHEET

	£	s.	d.	£	s.	d.		£	s.	d.	£	s.	d.
Capital				7,500	0	0	Fixed Assets—						
Profit and Loss Account:							Furniture—Branch				829	2	0
Balance . . .	188	0	0				Current Assets—						
Add Branch Profit .	733	19	7				Stock—Branch .	1,304	14	3			
	921	19	7				Debtors—Branch .	2,415	12	8			
Less Loss on Exchange . .	35	16	6				Cash at Bank—						
				886	3	1	Head Office .	826	0	0			
				8,386	3	1	Branch . .	3,117	15	6	7,664	2	5
Current Liabilities—													
Creditors . . .				107	1	4							
				£8,493	4	5					£8,493	4	5

(2) Actual entries in Head Office books—

Dr. BRANCH *Cr.*

	$	£	s.	d.		$	£	s.	d.
To Bank	32,067	6,862	0	0	By *Balance* . . c/d	35,480	7,560	3	1
" Profit and Loss Account	3,413	733	19	7	" Loss on Exchange .		35	16	6
	$35,480	£7,595	19	7		$35,480	£7,595	19	7
To *Balance* . b/d (*a*)	35,480	7,560	3	1					

Dr. PROFIT AND LOSS ACCOUNT *Cr*

		£	s.	d.			£	s.	d.
To Branch Account—					By Balance . .	b/d	188	0	0
Loss on Exchange		35	16	6	" Branch Account—				
" Balance . .	c/d	886	3	1	Branch Profit .		733	19	7
		£921	19	7			£921	19	7
					By Balance . .	b/d	886	3	1

BALANCE SHEET

	£	s.	d.		£	s.	d.
Capital . .	7,500	0	0	Cash at Bank .	826	0	0
Profit and Loss Account . .	886	3	1	Branch Account (*b*)	7,560	3	1
	£8,386	3	1		£8,386	3	1

(*a*) The value of $35,480 is made up of—

	£	s.	d.
Furniture	829	2	0
Debtors	2,415	12	8
Cash at Bank . .	3,117	15	6
Stock	1,304	14	3
	7,667	4	5
Less Creditors . .	107	1	4
	£7,560	3	1

(*b*) The combined Balance Sheet will now be prepared by substituting for the amount of £7,560 3s. 1d. the detailed assets and liabilities as shown in (*a*).

Note. The Capital Account is shown separate from the Profit and Loss Account for the sake of clarity.

It will now be clear that although in examination work the results may be quickly arrived at by placing the currency and sterling columns in juxtaposition, the accounting entries actually take place in the head office through the Branch Account. Nevertheless, it is possible, as has been shown, to proceed in columnar form with the combined Balance Sheet. In the same way, the Profit and Loss Account of the branch may be shown side by side with that of the head office, although this is somewhat unusual and generally impracticable.

Illustration. Transactions between the London and branch offices of a concern are converted in the books at 1s. 6d. to the rupee.

Assume the average rate for the period was 1s. 5d., the rate at date of Trial Balance was 1s. 4d., and that the fixed assets were originally acquired at 1s. 6d. to the rupee.

(*a*) Prepare Balance Sheet at, and Profit and Loss Account for period to 31st December, 19...

(*b*) Show Branch Current Account.

(Before proceeding to the draft accounts a rough Trial Balance should be prepared in respect of both Head Office and Branch, with a double set of columns for the latter, showing Rupees and the Sterling equivalents according to the rules already laid down.)

The final balances are—

	London	Branch
	£	Rupees
Branch Office (debit balance)	15,075	
Buildings		60,000
Capital	17,500	
Cash at Bank	10,185	12,600
Creditors	5,010	3,000
Debtors		15,000
Directors' Fees	500	19,000
General Expenses	850	
London Office (credit balance)		201,000
Machinery		120,000
Rent and Rates	400	12,500
Rent Receivable		75,000
Provision for Depreciation	2,000	
Salaries	500	87,000
Stock-in-Trade (at date)		90,000
Trading Profit for six months to date	3,000	137,100

Dr. BRANCH CURRENT ACCOUNT *Cr.*

	Rupees	£		Rupees	£
To Balance b/d	201,000	15,075	By Loss on Exchange		565
,, Branch Profit	93,600	6,630	,, Balance c/d	294,600	21,140
	294,600	£21,705		294,600	£21,705
To Balance b/d	294,600	21,140			

PROFIT AND LOSS ACCOUNTS

Dr. FOR THE SIX MONTHS ENDED 31ST DECEMBER, 19.. *Cr.*

	Branch	London		Branch	London
	Rupees	£		Rupees	£
To Directors' Fees .	19,000	500	By Trading Profit .	137,100	3,000
,, General Expenses		850	,, Rents Receivable . .	75,000	
,, Rent and Rates.	12,500	400			
,, Salaries . .	87,000	500			
,, Net Profit. c/d	93,600	750			
	212,100	£3,000		212,100	£3,000
		£			£
To Loss on Exchange		565	By Balances— b/d		
,, Balance c/d		6,815	Net Profit:		
			London .		750
			Branch .		6,630
			[93,600 Rs. @ 1/5]		
		£7,380			£7,380
			By Balance b/d		6,815

COMBINED BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£	£		£	£
Capital		17,500	Fixed Assets—		
Profit and Loss Account . .		6,815	Buildings—Branch . .		4,500
			Machinery—Branch . .	9,000	
		24,315	*Less* Provision for Depreciation—London . .	2,000	
Current Liabilities—					7,000
Creditors—					
London	5,010				11,500
Branch	200		Current Assets—		
		5,210	Stock-in-Trade—Branch .	6,000	
			Debtors—Branch . .	1,000	
			Cash at Bank—		
			London	10,185	
			Branch . . .	840	
					18,025
		£29,525			£29,525

The closing balance on the Branch Current Account in the London books is made up as follows—

	Rupees	Rate	£
		s. d.	
Buildings	60,000	1 6	4,500
Machinery	120,000	1 6	9,000
Stock	90,000	1 4	6,000
Debtors.	15,000	1 4	1,000
Cash	12,600	1 4	840
	297,600		21,340
Less Creditors	3,000	1 4	200
	294 600		£21,140

Note. This balance would appear to the credit of Head Office in the branch books and agrees with the Memorandum column of the Branch Account of the Head Office.

In recent years it has become more frequent to ignore this somewhat artificial appraisement of the sterling equivalent of currency trading operations and to ignore, as a result, any formal rate of conversion of the operations of a foreign Branch.

Instead of attempting to evaluate independently the profit or loss sterling equivalent, with a consequent balance treated as profit or loss on exchange, the growing practice is to take the sterling value of the closing assets and liabilities and automatically the balancing item in the sterling column of the Branch Account in the Head Office books as the profit or loss. This predicates that remittances to and from the branch have been brought into account.[1]

If this procedure is adopted in the above illustration the balance of profit as shown in the Branch Current Account will be £6,065 with no loss on exchange, the profit being the excess of closing balances in sterling £21,140 over the opening balances in sterling £15,075.

EXAMINATION PROBLEM

The following is a Trial Balance sent from the foreign branch of a London Company. In the London books the branch balance on 1st January, 19.., was £5,218; and on 30th June, 19.., the Remittance Account balance was £2,641. There was no cash in transit.

The Rates of Exchange were as follows—

1st January, 86½; 30th June, 91½. At the time of purchase of the Fixtures the rate was 124.

Prepare a Converted Trial Balance in columnar form, so as to disclose results of the operations of the six months.

How would you deal with the above details in order to show the Brańch results of trading and incorporate them in the London books?

(*Adapted from Institute of Chartered Accountants, Inter.*)

Trial Balance, 30th June, 19..

	Ptas.	Ptas.
Head Office Account, 1st January, 19..		451,373
Remittances to Head Office	236,062	
Fixtures and Fittings	26,040	
Sundry Debtors	171,288	
Stock, 1st January, 19..	87,365	
Sundry Creditors		57,828
Purchases	186,989	
Sales		270,738
General Expenses	68,352	
Cash in hand	3,843	
[Stock, 30th June, 19.., Ptas. 91,683]		
	779,939	779,939

[1] Examination questions have been known requiring this method to be used so that no difference on exchange appeared in the Head Office accounts, but with the Branch profit converted in accordance with the usual formula. In such a case it is obvious that a difference on exchange must arise and, if it is not to appear in the Head Office accounts, it *must* be put in the memorandum currency columns.

CONVERTED TRIAL BALANCE, 30TH JUNE, 19..

	Ptas.	Rate	Profit and Loss Account Dr. £	Profit and Loss Account Cr. £	Balance Sheet Dr. £	Balance Sheet Cr. £
Head Office Account	431,373	—				5,218
Remittances	236,062	—			2,641	
Fixtures and Fittings	26,040	124			210	
Sundry Debtors	171,288	91½			1,872	
Stock, 1st January	87,365	86½	1,010			
Sundry Creditors	57,828	91½				632
Purchases	186,989	[1] 89	2,101			
Sales	270,738	89		3,042		
General Expenses	68,352	89	768			
Cash in hand	3,843	91½			42	
Stock, 30th June	91,683	91½		1,002	1,002	
			(b) 3,879	(a) 4,044	5,767	5,850
Difference in Exchange			248			
Net Loss (after allowing for difference in Exchange)				83	83	
[1] i.e. $\frac{86\frac{1}{2} + 91\frac{1}{2}}{2}$			£4,127	£4,127	£5,850	£5,850

It will be observed that the question requires the Trial Balance to be drawn up so as to show results of the operations of the six months, hence a Profit and Loss and Balance Sheet column.

After conversion of items into sterling as above, Journal entries will be made as follows—

JOURNAL

			£	£
	Branch . . . . . *Dr.* To Profit and Loss Account . Being Profit for six months.		[1] 165	165
	Difference on Exchange . . *Dr.* To Branch . . . . . Being Difference in Exchange.		248	248

The Branch Account will then show a debit balance of £2,494, made up as follows—

		£
Opening Balance	*Dr.*	5,218
Less Remittances		2,641
		2,577
Less Journal transfers.		83
Closing Balance . .	*Dr.*	£2,494

Recording Assets and Liabilities in the Head Office Books. Although it is usual to keep entirely separate accounts for foreign branches, there is no reason why the assets and liabilities of the branch should not be recorded in the head office books. In this method the Branch Current Account is nothing more than a simple Cash Account, but as the actual Branch Cash Account in the foreign country will be in foreign currency, it will be necessary to employ

[1] Surplus of (*a*) over (*b*) in Converted Trial Balance above.

an additional column for currency in the head office books so as to account for the cash received, paid, and the balance. The branch double entry will be compiled from the *sterling* column. In short, the currency column is purely memorandum.

Illustration.

TRIAL BALANCE AT 1ST JANUARY

	Dr.	*Cr.*
	£	£
Fixed Assets	2,500	
Stock	1,000	
Cash in Hand[1]	200	
Remittance	400	
Sundry Assets	2,400	
Sundry Liabilities		700
Profit and Loss Account		800
Capital		5,000
	£6,500	£6,500

Accounts from the foreign branch, exchange taken at 10 pesos to £, were as follows for the year ended 31st December.—

	Dr.	*Cr.*
	Pesos	Pesos
Balance	2,000	
Sales	7,500	
Fixed Assets Purchased and Sold	500	5,660
General Expenses		3,500
Remittance Account	4,160	
Investment in Foreign Subsidiary		4,500
Balance		500
	14,160	14,160

Closing stock is valued at 7,800 pesos. The fixed assets sold were in the books at 800 pesos.

The procedure is simply to convert the above to sterling, to consider it (in a separate account) merely as a Cash Account and to complete the double entry. The opening balance is 2,000 pesos at 10 to £, which is the £200 appearing in the head office Trial Balance.

Dr. FOREIGN BRANCH CURRENT ACCOUNT *Cr.*

	Pesos	£		Pesos	£
To Balance b/d	2,000	200	By General Expenses	3,500	350
" Sales	7,500	750	" Fixed Assets purchased	5,660	566
" Fixed Assets sold	500	50	" Investment in Foreign Subsidiary	4,500	450
" Remittances	4,160	400	" Balance c/d	500	50
" Profit on Exchange		16			
	14,160	£1,416		14,160	£1,416
To Balance b/d	500	50			

[1] Sterling equivalent of 2,000 pesos.

Profit and Loss Account for the Year ended 31st December

Dr.	£	Cr.	£
To Stock	1,000	By Sales	750
„ General Expenses	350	„ Stock	780
„ Loss on Sale of Fixed Assets	30	„ Profit on Exchange	16
„ Profit	166		
	£1,546		£1,546

The Balance Sheet extracted by the head office will now be as follows—

Balance Sheet as at 31st December

	£		£
Capital	5,000	Fixed Assets[1]	2,986
Profit and Loss Account £800		Stock	780
Add Profit for year . 166		Sundry Assets	2,400
	966	Investments	450
Sundry Liabilities	700	Cash in Hand	50
	£6,666		£6,666

Capital Expenditure and its Recording. (1) Where the head office incurs large expenses of a capital nature in connection with a foreign branch, it will debit the branch in currency (memo.) and in sterling; and the branch will debit the asset and credit head office. The practice is to ignore fluctuations of exchange and upon incorporating the results of the branch activities in the head office books to bring into the valuation of the worth of the branch the asset, if of a fixed nature, at the rate of exchange ruling as at the date of its acquisition, subject to depreciation, which will be converted, not at the average rate of exchange of the period, but at the same rate as at the date of acquisition.

(2) If desired, the head office may show the branch asset as a separate account in its own books, in which case the cost in sterling will be debited, not to branch but to Branch Asset Account, so that no conversion from foreign currency into sterling is required. No entry will be made in the branch books. In other words, the entry in no way affects the reflective Head Office and Branch Accounts, the book-keeping entry being precisely the same as that of acquiring a "home" asset. If desired, a memorandum column may be employed to show the amount of currency involved in the expenditure.

It will, however, be advisable to write off depreciation, whichever method of recording the fixed assets be adopted.

If the first method is used the amount of depreciation will automatically appear in the branch books, and its conversion in head

[1] I.e. £2,500 + £566 − £50 − £30.

office books will be made at the rate ruling as at the date of acquiring the asset.

If the second method is used the depreciation will be recorded in the ordinary way in the head office books, except that it will be debited against the Branch Profit and Loss Account.

(3) Where capital expenditure is incurred by the branch, the entry will be to the debit of the asset and to the credit of cash (or supplier), unless it is intended to have the record of the asset in the head office books, in which case the head office will be debited and cash or supplier credited. It will then be necessary for the head office to debit the branch asset in sterling with the currency equivalent in the memorandum column and credit the branch.

BRANCH CONTROL

The question of branch control is an important one, and is such that no hard and fast rules can be laid down, as much depends on the existing circumstances, e.g. the number of branches, the type of operations, commodities, or services, the degree to which the branches are self-contained, location, special local conditions, and the like.

The chief aims of branch control are—

(1) To supervise stock, making the branch accountable to the head office; thus, where possible, there will be required from the branch returns showing the receipts, returns and sales of goods, the goods being charged to branch at either selling price or at cost plus a percentage. Supplementing this may be an inspection staff whose duty it is to make surprise visits to branches in order to inspect and check the branch records. So far as possible, it will be advisable to have all goods supplied by head office.

(2) To avoid losses by reason of bad debts, and to this end the branch may be required to furnish details as to the amount and age of its debts, so that as required these accounts may be handed over to the head office for collection. Usually strict limitations are placed upon the branch in regard to credit allowed to customers.

(3) To prevent—especially where the branch is staffed by one person—the branch from exercising fraudulent manipulations (e.g. the staff selling its *own* goods) by comparing percentages of profit, comparison of results of various branches, fixation of a minimum amount of goods that should normally be sold within a period, close watch on periodical variations in sales and the like.

(4) To avoid extravagance in expenses by requiring the branch to account for its expenditure, and making comparisons of comparative efficiencies of the branches, e.g. sales, gross and net profit per £ of sales, or per person employed, or per £100 of capital sunk in the branch.

(5) To prevent pilfering of cash by requiring a weekly cash statement and daily bankings. The branch, if retail, will be required to employ cash registers, counter books, tear-off checks (as in restaurants) so that either the cash is not handled by any person other than the cashier or, if it is necessary for all the staff to receive it, they will be required to complete the forms used at the back of the counter books—a duplicate invoice receipt being given to the customer.

Occasionally, where there are "regular" customers, an invoice receipt may be given to the customer, which, upon his having collected a stipulated number, may be presented to the shop for exchange into an article, thus facilitating comparison with the entries at the back of the counter books and encouraging custom.

It is obviously advisable to charge up goods to branch at selling price if practicable, but where prices are highly fluctuating on either the buying or the selling side, or branch labour is to be expended, or where many purchases are made locally, it will be usually found unreliable, so that the method of charging up at cost plus percentage expected to be earned may better serve the aim in view, although under this method it may be extremely difficult to fix with reasonable accuracy the required percentage. In the case of a branch with many lines, the management usually are content to fix an approximate percentage by "sampling," that is, by taking at random a proportion only of the goods transferred and by comparing cost and selling price and basing the required percentage on those comparisons for each period, say, monthly. It is quite clear that academically this is not accurate, particularly as SEVERAL different percentages may obtain during the period, but experience, trial and error usually enable the percentage to be forecast with sufficient accuracy to answer all reasonable requirements.

In order to keep the percentage figures as accurate as possible, the "loading" is usually confined to the bare cost of the goods, ignoring indirect expenses.

In the head office an Abstract Book will be kept containing the above information, so that at any time it will be possible to ascertain:

Total sales and returns—divided into cash and credit [with quantities, where possible].

Weekly average of sales.

Total (and separate) expenses.

Weekly average of expenses.

Stock records.

Weekly amounts and values of stocks retained in branches.

Debtors separately showing those transferred to Head Office for collection.

Approximate gross and net profit (after allowing for DEPRECIATION, INTEREST, and, if necessary, a share of the head office expenses).

Obviously, the precise form of the branch control will be based on the particular circumstances, as will the reliability of the inferences deducible from the returns, e.g. stock may be such that an accurate percentage of profit can be always gauged, as where certain articles are packed goods sold at a fixed price. On the other hand, where there is intense local competition, or the goods are both perishable and/or subject to rapid price fluctuations, no rigid percentage can be fixed. The branch manager may be "tuned up" to earn a certain percentage on sales, but a certain reasonable allowance must be given. Again, a branch may be a manufacturing or productive one, whilst in any case circumstances may dictate a departure from the ordinary routine. In the case of many concerns, e.g. as in the large stores in London and the provinces, the post season sale will vitiate normal percentages.

Account must be taken of and adjustments made accordingly for price alterations, wholesale or retail, whilst full cognizance must be taken of price differentiation as where prices are reduced for purchases of large quantities. Even where prices are fixed, careful stock recording will be entailed if there are several different sizes of commodity, each having a proportionately different price as, for instance, patent medicines, as very frequently "treble size" bottles or tins are sold at the price of two "single" sizes.

Many points of detail will arise in addition, such as the proper system of stock and store preserving, e.g. suitable warehousing, storing, shelving, internal transport, protection from weather changes and from destruction by vermin.

In the case of retail branches, it is usual to have a weekly or other periodical return, on the following lines, modified to meet the circumstances.

Town............................

Branch No................. Week ended................

BRANCH RETURN

Receipts																
Day	Cash Sales									Receipts from Debtors per Receipt Books	Total			Paid into Bank		
	Dept.			Dept.			Dept.							Date	Amoun	
	£	s.	d.	£	s.	d.	£	s.	d.	Receipt No.	£	s.	d.		£	s.
Monday .																
Tuesday																
Wednesday .																
Thursday .																
Friday .																
Saturday .																

The columns are ruled on the receipts side to accommodate the various departments.

DEBITS TO DEBTORS (CREDIT SALES)

	Dept.			Dept.			Dept.			Total		
	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.
Monday												
Tuesday.												
Wednesday												
Thursday												
Friday												
Saturday												
Total												
Commencing Debtors . .												
Total								[1]	£			

CREDITS TO DEBTORS

	£ s. d.
Cash received from Debtors	
Returns from Debtors	
Bad Debts / Discounts / Allowances } (per List)	
Transfers to Head Office (per List)	
Closing Debtors	
Total . . . . [1]	

[The details are shown below in Ledger form for sake of clarity.

Dr.	£ s. d.		*Cr.* £ s. d.
Commencing Debtors		Cash received from Debtors . .	
Sales		Returns from Debtors . . .	
		Bad Debts	
		Discounts	
		Allowances	
		Transfers to Head Office . .	
		Closing Debtors	
	£		£]

EXPENDITURE

Details	Voucher No.	Amount £	s.	d.
Wages				
Cleaning				
Etc.				
Etc.				
Sundry Local Purchases per List .	. .			
Total . .	. .			
Add Petty Cash on hand . .	. .			
Imprest Total	. £			

[1] These totals should agree.

STOCKS

	£	s.	d.
Commencing Stock			
Receipts from Head Office			
Sundry Local Purchases			
Less Net Sales (at cost)			
Returns to Head Office			
Closing Stocks . . . . £			

[Signed and dated]

Observations, e g. as to holidays, staff changes, local conditions, opening up or closing down of local competitive shop, results of advertising campaigns, etc.

In brief summary form the following may be cited as the main headings of branch control—

(1) Accounting at head office.

(2) Systematic stock control.

(3) Adherence to the terms of sale, e.g. prices, credit (if any), transfer of debts of doubtful nature to head office.

(4) Local purchases forbidden, or within prescribed limits.

(5) Periodic detailed returns.

(6) Daily bankings, imprest for petty cash.

(7) Surveillance of overheads.

(8) Establishment of a MINIMUM sale per period (per convenient unit).

(9) Surprise inspections as to stock, store conditions, CIVILITY of staff, cash recording, debtor balances, allowances and discounts, AGE of debts, internal audit staffs, etc.

(10) Quantitative control where possible, e.g. gramophones, motor-cars, heavy furniture, jewellery, antiques, packed goods, etc.

(11) Statistical data, comparisons, index figures, graphs, and their interpretation in the light of general economic conditions, conditions affecting the class of trade (e.g. changes in fashions, eclipse of gramophones by radio, revival of demand for pianos), and those applicable solely to local conditions (e.g. competition by co-operative societies, closing down of works upon which a large proportion of the local customers depends).

CHAPTER XX

HIRE PURCHASE ACCOUNTS

BY hire purchase is meant the system under which property or a chattel is acquired by payments made in instalments, during the period of which the title in the property remains with the hire vendor. The payments prior to the final one are regarded as being purely in respect of hire, and the title in the property does not pass to the hire purchaser until such final payment.

The owner parts with the *possession* of his property (but not with the *ownership*) to the other party on condition that the latter fulfils his obligation to pay his instalments, on completion of which the ownership is transferred to the hire purchaser.

The agreement usually contains a clause providing that the owner may recover his property in the event of default of the buyer in paying any one of his instalments.

As the instalments payable are really intended to be made on account of the purchase price, they are much greater than for ordinary hire. It would often entail a hardship to the hire purchaser if, having paid most of his instalments, he became unable to complete the payments of the remainder, consequently being deprived of the property in his possession whilst remaining liable for the outstanding instalments. To mitigate such a misfortune, the hire purchase agreement usually contains a proviso under which the hire purchaser is permitted to return the property during the currency of the agreement on condition that payment of all accrued instalments is made, thus converting the agreement into one of hire. Alternatively, under certain conditions the hire purchaser may be allowed to retain a certain part of the property, or the hire vendor may make an allowance for the property returned to him by the hire purchaser.

Hire purchase transactions must be clearly distinguished from actual sales, the payments for which are made in instalments (i.e. the deferred payment method), for in the latter case the title in the property has actually been transferred—not merely the possession, but the full legal ownership. In spite of the fact that the bookkeeping entries are often treated alike, the fundamental difference should be constantly kept in mind. In hire purchase the hire vendor still retains ownership, so that the question of valuation and insurance of the property is a material one for him to bear in mind.

On the other hand, if a *sale* has been made, *payment* of the price being made by the buyer in instalments, the asset has changed not only its location but its legal form, inasmuch as the money value of the property is now represented in the vendor's books by a debtor. In other words, under hire purchase the property is still

the hire vendor's, the hire purchaser being a debtor only for accrued instalments, while under the deferred payment plan the buyer is a debtor for the purchase price of the property, less the instalments paid.

The contrasts may be summarized as follows—

Hire—

Property *must* be returned to owner.

Sale—

Property *cannot* be returned to sender.

Hire-Purchase—

Property may be either *returned or retained* by the hire purchaser, *at his own option.*

It will be clear that the vendor, or the hire vendor, as the case may be, will make a charge not only for what is described as the "cash price" but also for interest and the risk involved, for even in hire purchase the hire vendor may incur loss due to the return of badly damaged property as well as costs of transport and storage.

Hire Purchase Act, 1938. The legal relationship between the Hire Purchaser and the Hire Vendor are affected by the Hire Purchase Act, 1938, which came into force on the 1st January, 1939. The main provisions of the Act are—

(1) The Act embraces ALL contracts of Hire Purchase and Credit Sale where the *total* price does not exceed—

(*a*) £50 for a Motor Vehicle, Railway Wagon or Railway Rolling Stock,

(*b*) £500 for Livestock, and

(*c*) £100 in any other transaction.

(2) The *cash* price at which the goods could be purchased immediately and outright must be disclosed *before* any contract of Hire Purchase is entered into, and similarly with any credit sale agreement where the price exceeds £5. If the owner or vendor fails so to do, he cannot enforce the agreement (or any guarantee or security therefor) subject to the Court's discretion in certain circumstances.

(3) The hirer may terminate his agreement by notice in *writing* at any time before the last payment falls due, but he is still bound to pay

(*a*) any amounts falling due prior to the above notice, PLUS

(*b*) the amount by which one half of the purchase price (or such less amount as is specified in the agreement) EXCEEDS the total sums paid and due under the agreement, and

(*c*) damages (if any) for failure to take reasonable care of the goods comprised in the contract. He is under obligation also to return the goods to the Vendor.

(4) Certain conditions and stipulations which are often included in Hire Purchase agreements (which operate unfairly to Hire Purchasers) are declared void.

(5) A Hirer or Buyer is entitled to require the Hire Vendor, at any time before the final payment has been made and on tendering the sum of one shilling, to supply him with a copy of any note or memorandum of the agreement and various details as to the amounts already paid, the amounts due but unpaid and the future payments to be made.

(6) A Hire Purchaser must keep the goods under his possession and control and, if requested by the Hire Vendor, inform him where the goods are.

(7) Several conditions and warranties are implied in every Hire Purchase agreement, notwithstanding *any* provision or agreement to the contrary, e.g. right of quiet possession.

(8) If a Hire Purchaser has two (or more) agreements running, he has the right of appropriation where an amount paid is less than the total of the amounts then due. Otherwise the appropriation is proportionate to the amounts outstanding on all the agreements.

(9) When the total amount paid (or tendered) under a Hire Purchase agreement *equals* or *exceeds* one-third of the Hire Purchase price, the Hire Vendor is not permitted to obtain repossession except by consent of the County Court, and on the commencement of any such action the Vendor cannot enforce payment of any sum, except by claim in the action. In such an action, the Court may order—

(*a*) redelivery unconditionally,
(*b*) redelivery under certain conditions, or
(*c*) redelivery of part of the goods.

Accounting Methods. Many systems of accounting are in vogue, some scientific, others crude, but the principle involved in *all* is that the profit is not earned until the final instalment has been paid; hence, some provision must be made to avoid showing inflated profits. It can readily be perceived that no rigid rule of accounting can be laid down owing to the large number of varying circumstances in different businesses, e.g. nature of the property, the number and regularity or otherwise of the "Sales," the length of the instalment period (long, medium, or short); the ratio of defaulters to sound customers, financial policy, size and capacity of accounting staff, and the proportion of this class of business to others.

It will be convenient to treat hire purchase transactions under the following heads—

HIRE VENDOR'S BOOKS

(A) Sales Method—

(1) Each transaction, *including* interest, is treated as a sale, the usual entries being made, no separate account appearing for interest.

(2) Each transaction, *excluding* interest, is treated as a sale and interest is charged to the hire purchaser and recorded separately.

The entries are—

(*a*) Upon delivery of goods or property—

Debit Hire Purchaser — [1] Credit Hire Purchase Sales

(*b*) Upon interest becoming due periodically—

Debit Hire Purchaser — Credit Interest

Alternatively, the hire vendor may credit Trading Account for the sale in two parts: (*a*) proportion representing hire, and (*b*) proportion representing sale. (This method is purely academic as the enormous detailed calculations involved render it impracticable.)

Illustration. A sells machinery on hire purchase to B, the cash price being £1,000. The hire purchaser agrees to pay in two instalments each half year with interest at 5 per cent per annum, the interest to be paid each half year in addition to the amount due on the machinery. Show B's account in A's books.

HIRE VENDOR'S BOOKS—

Dr. B *Cr.*

			£	s.	d.				£	s.	d.
	To Machinery. (*a*)		1,000	0	0		By Cash		525	0	0
	,, Half-year's Interest on £1,000 at 5% per annum (*b*)		25	0	0		,, Balance	c/d	500	0	0
			£1,025	0	0				£1,025	0	0
	To Balance	b/d	500	0	0		By Cash		512	10	0
	,, Half-year's Interest on £500 at 5% per annum		12	10	0						
			£512	10	0				£512	10	0

(*a*) Credit Hire Purchase Sales Account (through the Sales Day Book).
(*b*) Credit Interest Account (through the Interest Journal).

It is important to observe in all cases whether the first payment is to be made at the time of delivery (i.e. "cash down") or at the end of the first period.

The agreement might provide for the instalments to be EQUAL, as distinct from equal proportions of the cash price. The payment of each instalment is of a composite nature as it includes both principal (or cash price) and interest, each subsequent payment discharging an increasingly greater proportion of the principal than the one preceding it.

Illustration. Assume that the facts are as in the foregoing illustration, except that the two payments are to be EQUAL. The instalment required to the nearest penny is £518 16s. 6d. Show B's account in A's books.

[1] Alternatively the term "Hire Sales" is employed.

HIRE VENDOR'S BOOKS—

Dr. B *Cr.*

		£	s.	d.			£	s.	d.
To Machinery .		1,000	0	0	By Cash .		518	16	6
,, Interest .		25	0	0	,, Balance .	c/d	506	3	6
		£1,025	0	0			£1,025	0	0
To Balance .	b/d	506	3	6	By Cash .	[1]	518	16	7
,, Interest .		12	13	1					
		£518	16	7			£518	16	7

[1] Calculated to the nearest penny

The hire vendor will show in his Balance Sheet the amount due (as if an actual sale had taken place) from the hire purchaser, but as in the case of the latter, some designating expression should be employed to indicate that the subject matter is that of hire purchase. Whether it is described as a debtor for hire purchase (from a meticulous point of view inaccurate) or goods out on hire purchase, is not of material importance so long as a clear reference is made to the nature of the asset. As regards the hire purchaser's books, which will be dealt with later in this chapter, a phrase, termed EQUITY, is occasionally used in juxtaposition to the asset described, and if, despite this phrase, it is clearly understood that the title to the property is not in the hire purchaser, it is quite acceptable; but from a purist's point of view, the term is not entirely unchallengeable as the hire purchaser's position, though analogous to, is not that of having a full equitable interest.

No depreciation will be dealt with (as the asset is considered as a sale) but provision should be made in respect of loss likely to be entailed if the property is returned in a damaged condition.

A variation of the above method is to debit the hire purchaser with the whole sum—cash price and interest, crediting respectively hire purchase sales and Interest Suspense Account: at the end of each year the proportionate amount of interest arising during the year is debited to Interest Suspense Account and credited to Interest Account, and thence to Hire Purchase Trading Account. In the meantime, the balance in credit is shown as a deduction from hire purchase debtors.

Illustration. A delivers machinery on the hire purchase system for £2,500 to be paid as follows: on delivery, £400; at the end of the first year, £600; second year, £400; third year, £1,100; interest, included in the £2,500, being charged on the cash value at 10 per cent per annum. Show entries in the books of the hire vendor.

HIRE VENDOR'S BOOKS—

Dr. HIRE PURCHASER *Cr.*

			£	s.	d.				£	s.	d.
Year 1	To Hire Purchase Sales[1] .		2,500	0	0	Year 1	By Cash Deposit .		400	0	0
							,, Cash (1st inst.)		600	0	0
							,, Balance .	c/d	1,500	0	0
			£2,500	0	0				£2,500	0	0
Year 2	To Balance .	b/d	1,500	0	0	Year 2	By Cash (2nd inst.)		400	0	0
							,, Balance .	c/d	1,100	0	0
			£1,500	0	0				£1,500	0	0
Year 3	To Balance .	b/d	£1,100	0	0	Year 3	By Cash (3rd and last instalment)		£1,100	0	0

Dr. INTEREST SUSPENSE *Cr.*

			£	s.	d.				£	s.	d.
Year 1	To Interest Account		170	5	0	Year 1	By Hire Purchaser		397	10	5
	,, Balance .	c/d	227	5	5						
			£397	10	5				£397	10	5
Year 2	To Interest Account		127	5	5	Year 2	By Balance .	b/d	227	5	5
	,, Balance .	c/d	100	0	0						
			£227	5	5				£227	5	5
Year 3	To Interest Account		£100	0	0	Year 3	By Balance .	b/d	£100	0	0

The interest is calculated as follows—

		£	s.	d.		£	s.	d.		£	s.	d.
3rd year .	$\frac{1}{11}$ ×	1,100	0	0	=	100	0	0	= $\frac{1}{10}$ ×	1,000	0	0
2nd year .	$\frac{1}{11}$ ×	1,400	0	0	=	127	5	5	= $\frac{1}{10}$ ×	1,272	14	7
1st year .	$\frac{1}{11}$ ×	1,872	14	7	=	170	5	0	= $\frac{1}{10}$ ×	1,702	9	7[2]

(3) Interest Suspense Method.

The third method is adopted by concerns having a large number of transactions, with the instalments extending over fixed periods, and is known as the Interest Suspense Method. It aims at crediting the period in which the sale is made with the gross profit thereon, separating the interest appertaining to each transaction, and allocating it over the years during which the instalments are paid. Separate sales day books must be kept to record the sales of each different duration, e.g. "twelve-monthly instalments."

The amount chargeable to the hire purchaser is divided into hire purchase sales and interest, the double entry being—

Debit Hire Purchaser.
Credit Hire Purchase Sales Account.
Credit Interest Suspense Account.

The latter is allocated to Trading Account proportionately over the length of the instalment period by debiting such proportion to Interest Suspense Account and crediting Trading Account.

[1] £2,102 9s. 7d. to credit of Hire Purchase Sales and £397 10s. 5d. to Interest Suspense Account.

[2] £2,500, *less* deposit £400, *less* interest £397 10s. 5d.

Illustration. If the instalments are paid quarterly and are spread over thirty-six months, and interest at 10 per cent per annum is charged, it will be found that the interest credited to Interest Suspense Account should be allocated as follows—

1st Year . . .	52·4%	of the total interest
2nd „ . . .	33·9%	„ „
3rd „ . . .	13·7%	„ „
	100·0%	

The above result is obtained as under—

Assume the hire purchase price of a piano is £106 12s., to be paid for in thirteen quarterly instalments of £8 4s., the first instalment to be paid when the "sale" is effected and interest at 10 per cent per annum to be charged.

The cash price of the piano is £84 2s. 3d. plus the deposit of £8 4s. = £92 6s. 3d.

A table may be constructed as follows—

	Balance				Interest[1]			Total			Instalment			Balance		
	£	s.	d.		£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.
Year 1 .	92	6	3					92	6	3	8	4	0	84	2	3
	84	2	3	$\frac{1}{41}$ × £86/ 4/ 4	2	2	1	86	4	4	8	4	0	78	0	4
	78	0	4	$\frac{1}{41}$ × £79/19/ 4	1	19	0	79	19	4	8	4	0	71	15	4
	71	15	4	$\frac{1}{41}$ × £73/11/ 2	1	15	10	73	11	2	8	4	0	65	7	2
	65	7	2	$\frac{1}{41}$ × £66/19/10	1	12	8	66	19	10	8	4	0	58	15	10
					£7	9	7									
Year 2 .	58	15	10	$\frac{1}{41}$ × £60/5/ 3	1	9	5	60	5	3	8	4	0	52	1	3
	52	1	3	$\frac{1}{41}$ × £53/7/ 3	1	6	0	53	7	3	8	4	0	45	3	3
	45	3	3	$\frac{1}{41}$ × £46/5/10	1	2	7	46	5	10	8	4	0	38	1	10
	38	1	10	$\frac{1}{41}$ × £39/0/11		19	1	39	0	11	8	4	0	30	16	11
					£4	17	1									
Year 3 .	30	16	11	$\frac{1}{41}$ × £31/12/4		15	5	31	12	4	8	4	0	23	8	4
	23	8	4	$\frac{1}{41}$ × £24/ 0/1		11	9	24	0	1	8	4	0	15	16	1
	15	16	1	$\frac{1}{41}$ × £16/ 4/0		7	11	16	4	0	8	4	0	8	0	0
	8	0	0	$\frac{1}{41}$ × £ 8/ 4/0		4	0	8	4	0	8	4	0	*nil*		
					£1	19	1									

The "spread" of the interest of £14 5s. 9d. is as follows—

$$\text{1st year } \frac{£7\ 9s.\ 7d.}{£14\ 5s.\ 9d.} \times 100\% = 52{\cdot}4\%$$

$$\text{2nd year } \frac{£4\ 17s.\ 1d.}{£14\ 5s.\ 9d.} \times 100\% = 33{\cdot}9\%$$

$$\text{3rd year } \frac{£1\ 19s.\ 1d.}{£14\ 5s.\ 9d.} \times 100\% = 13{\cdot}7\%$$

[1] The entry in this column is 2½ per cent [i.e. 10 per cent per annum on balance], e.g. 2½ per cent on £84 2s. 3d. = £2 2s. 1d.

The table can be easily proved by working back from the end. The last payment of £8 4s. discharges the balance owing in the penultimate quarter plus interest thereon at 2½ per cent. Such interest is $\frac{2\frac{1}{2}}{102\frac{1}{2}}$ or $\frac{1}{41}$ × £8 4s. = 4s.; thus the balance at the beginning of the last quarter is £8. The interest for the penultimate period is $\frac{1}{41}$ × £16 4s. = 7s. 11d., and so on.[1]

It is obvious that as the instalments are spread over three years, unless the sale is made on the 1st January in any year (assuming the accounting period to end 31st December) the instalments will be received during four accounting periods, and accordingly the interest for the three years must be divided amongst the four accounting periods in which the instalments are received. It is quite impracticable to do this accurately by taking every sale and making a mathematical calculation in respect thereof; accordingly an average basis is taken. One method is to assume that all the sales are made half-way through the financial period and to assume that the interest is spread over each year evenly. With the above figures the interest would be spread over as follows—

1st accounting period—	½ × 52·4%	= 26·2%
2nd accounting period—	½ × 52·4% + ½ × 33·9%	= 43·1%
3rd accounting period—	½ × 33·9% + ½ × 13·7%	= 23·8%
4th accounting period—	½ × 13·7%	= 6·9%
Total		100·0%

If the first accounting period half year is taken as the basis of the calculation, the second accounting period being made up of the second half of the first year plus the first half of the second year and so on, the percentages will be more accurately—

1st Accounting period—

1st half, 1st year . . $\frac{£4\ 1s.\ 1d.}{£14\ 5s.\ 9d.} \times 100\%$ = 28·3%

2nd Accounting period—

2nd half, 1st year . . $\frac{£3\ 8s.\ 6d.}{£14\ 5s.\ 9d.} \times 100\%$

1st half, 2nd year . . $\frac{£2\ 15s.\ 5d.}{£14\ 5s.\ 9d.} \times 100\%$

$\left.\begin{array}{l} \frac{£3\ 8s.\ 6d.}{£14\ 5s.\ 9d.} \times 100\% \\ \frac{£2\ 15s.\ 5d.}{£14\ 5s.\ 9d.} \times 100\% \end{array}\right\} = \frac{£6\ 3s.\ 11d.}{£14\ 5s.\ 9d.} \times 100\%$ = 43·4%

[1] If the student finds the computation difficult, the above schedule should be built up in Ledger form, for example—

First Quarter of Year 2—

Dr. HIRE PURCHASER *Cr.*

		£	s.	d.			£	s.	d.
To Balance . . .	b/d	58	15	10	By Cash		8	4	0
,, Interest . . .		1	9	5	,, Balance. . .	c/d	52	1	3
	£	60	5	3		£	60	5	3
To Balance . . .	b/d	52	1	3					

3rd Accounting period—

2nd half, 2nd year .	$\frac{£2\ 1s.\ 8d.}{£14\ 5s.\ 9d.} \times 100\%$	$\left.\right\} = \frac{£3\ 8s.\ 10d.}{£14\ 5s.\ 9d.} \times 100\%$
1st half, 3rd year . .	$\frac{£1\ 7s.\ 2d.}{£14\ 5s.\ 9d.} \times 100\%$	$= 24{\cdot}1\%$

4th Accounting period—

2nd half, 3rd year. .	$\frac{11s.\ 11d.}{£14\ 5s.\ 9d.} \times 100\%$
	$= 4{\cdot}2\%$

An alternative method is to find the average due date of the sales, having regard to the seasonal fluctuations of the business. It may then be found that each of the three full years' interest is split, say, eight months to the first year, eight months and four months to the second year, etc.

Taking the first two periods, the "spread" would be—

1st period. . . $\frac{2}{3} \times 52{\cdot}4\%$
2nd period. . . $\frac{1}{3} \times 52{\cdot}4\% + \frac{2}{3} \times 33{\cdot}9\%$

Separate calculations will obviously be made in respect of each type of sale, each having its own Interest Suspense Account. Thus if the sales of three types are spread over three years, there will always be twelve Suspense Accounts open at any one time, that is, four for each type.

Illustration. Assuming that the interest is allocated as on page 486, (first method) show the entries necessary to record the foregoing transactions in the Hire Vendor's books, taking 1952 as the first year—

Dr. HIRE PURCHASE INTEREST SUSPENSE—1952 SALES *Cr.*

			£	s.	d.				£	s.	d.
1952 Dec. 31	To Transfer: Profit and Loss Account	(a)	3	14	10	1952 Dec. 31	By Interest per Hire Purchase Sales Day Book . .	1	14	5	9
	,, Balance . .	c/d	10	10	11						
			£14	5	9				£14	5	9
1953 Dec. 31	To Transfer: Profit and Loss Account	(b)	6	3	2	1953 Jan. 1	By Balance . .	b/d	10	10	11
	,, Balance . .	c/d	4	7	9						
			£10	10	11				£10	10	11
1954 Dec. 31	To Transfer: Profit and Loss Account	(c)	3	8	0	1954 Jan. 1	By Balance .	b/d	4	7	9
	,, Balance . .	c/d		19	9						
			£4	7	9				£4	7	9
1955 Dec. 31	To Transfer: Profit and Loss Account	(d)		19	9	1955 Jan. 1	By Balance . .	b/d		19	9

(a) 26·2% × £14 5s. 9d.
(b) 43·1% × £14 5s. 9d.
(c) 23·8% × £14 5s. 9d.
(d) 6·9% × £14 5s. 9d.

[1] See footnote on the next page.

Dr. **HIRE PURCHASE DEBTORS** Cr.

			£	s.	d.				£	s.	d.
1952 Dec. 31	To Hire Purchase Sales per Day Book	1	106	12	0	1952 Dec. 31	By Cash Instalments received during year		41	0	0
							" Balance	c/d	65	12	0
			£106	12	0				£106	12	0
1953 Jan. 1	To Balance	b/d	65	12	0						

For the purpose of illustration it is assumed that there was one transaction only

The example illustrates the principle involved following through the Interest Suspense Account method during the period of instalments, but it deals with one year's sales only. Normally, there would be further sales in subsequent years, and if the spread of interest is over four years there will be four Suspense Accounts in respect of each type of sale when the business has been established four years, and henceforward one will drop out as another is added. This may be shown by the following example—

Illustration. A Hire Purchase business is started and the Hire Purchase sales are—

1st Year	£1,000,	of which £200 is interest
2nd Year	£1,200,	" £250 "
3rd Year	£3,000,	" £580 "
4th Year	£2,800,	" £520 "
5th Year	£5,000,	" £950 "

Assume that the interest is allocated as follows (all the sales spreading over four years)—

1st Year	25%
2nd Year	50%
3rd Year	15%
4th Year	10%
	100%

Show Interest Suspense Accounts.

[1] The double entry will be effected by passing the transaction through the Hire Purchase Sales Day Book, thus—

Date	Details	Fo.	Total			Hire Purchase Sales			Interest Suspense		
			£	s.	d.	£	s.	d.	£	s.	d.
			106	12	0	92	6	3	14	5	9

Dr. INTEREST SUSPENSE (*Year* 1) *Cr.*

			£	s.	d.			£	s.	d.
Year 1	To Profit and Loss Account	25%	50	0	0	Year 1	By Sundry Debtors .	200	0	0
2	" " "	50%	100	0	0					
3	" " "	15%	30	0	0					
4	" " "	10%	20	0	0					
			£200	0	0			£200	0	0

Dr. INTEREST SUSPENSE (*Year* 2) *Cr.*

			£	s.	d.			£	s.	d.
Year 2	To Profit and Loss Account	25%	62	10	0	Year 2	By Sundry Debtors .	250	0	0
3	" " "	50%	125	0	0					
4	" " "	15%	37	10	0					
5	" " "	10%	25	0	0					
			£250	0	0			£250	0	0

Dr. INTEREST SUSPENSE (*Year* 3) *Cr.*

			£	s.	d.			£	s.	d.
Year 3	To Profit and Loss Account	25%	145	0	0	Year 3	By Sundry Debtors .	580	0	0
4	" " "	50%	290	0	0					
5	" " "	15%	87	0	0					
6	" " "	10%	58	0	0					
			£580	0	0			£580	0	0

Dr. INTEREST SUSPENSE (*Year* 4) *Cr.*

			£	s.	d.			£	s.	d.
Year 4	To Profit and Loss Account	25%	130	0	0	Year 4	By Sundry Debtors .	520	0	0
5	" " "	50%	260	0	0					
6	" " "	15%	78	0	0					
7	" " "	10%	52	0	0					
			£520	0	0			£520	0	0

Dr. INTEREST SUSPENSE (*Year* 5) *Cr.*

			£	s.	d.			£	s.	d.
Year 5	To Profit and Loss Account	25%	237	10	0	Year 5	By Sundry Debtors .	950	0	0
6	" " "	50%	475	0	0					
7	" " "	15%	142	10	0					
8	" " "	10%	95	0	0					
			£950	0	0			£950	0	0

Dr. PROFIT AND LOSS (*Year* 1) *Cr.*

			£	s.	d.			£	s.	d.
						Year 1	By Interest Suspense Account (1)	50	0	0

Dr. PROFIT AND LOSS (*Year* 2) *Cr.*

			£	s.	d.
Year 2	By Interest Suspense Account	(1)	100	0	0
	" " "	(2)	62	10	0

Dr. PROFIT AND LOSS (*Year* 3) *Cr*

			£	s.	d.
Year 3	By Interest Suspense Account	(1)	50	0	0
	" " "	(2)	125	0	0
	" " "	(3)	145	0	0

Dr. PROFIT AND LOSS (*Year* 4) *Cr.*

			£	s.	d.
Year 4	By Interest Suspense Account	(1)	20	0	0
	" " "	(2)	37	10	0
	" " "	(3)	290	0	0
	" " "	(4)	130	0	0

Dr. PROFIT AND LOSS (*Year* 5) *Cr.*

			£	s.	d.
Year 5	By Interest Suspense Account	(2)	25	0	0
	" " "	(3)	87	0	0
	" " "	(4)	260	0	0
	" " "	(5)	237	10	0

The Interest Suspense Account (year 1), it will be observed, is exhausted after four allocations to Profit and Loss Account at the end of the fourth period, as is Interest Suspense Account (year 2) at the end of the fifth period. In the next year, an Interest Suspense Account (year 6) would come into being, there being always four such accounts in the books in respect of each type of hire purchase sale, extending over four periods. Similarly, there would always be three in the books in respect of a type extending over three accounting periods.

The problem, it is evident, merely involves writing off from the Suspense Accounts the proportion of interest allocable to particular years to Profit and Loss Account (or to the Hire Purchase Trading Account in the first place). The balances on the Suspense Accounts will be shown on the Balance Sheet as deductions from Hire Purchase debtors.

Where the necessary *percentages* are given, the amount to be written off in any year is easily arrived at, e.g. taking Suspense Account (year 1) which, as has been demonstrated, has been credited to Profit and Loss Account in four instalments in the proportions: year 1, 25 per cent; year 2, 50 per cent; year 3, 15 per cent; year 4, 10 per cent. Sometimes a question appears in which the original suspense figure is not given, but a balance after one or more years have been written off, e.g. in reference to the above illustration, the balance of Suspense Account (Year 1) as at the beginning of

the third year, i.e. £50. As 75 per cent has been written off, therefore 25 per cent remains, of which 15 per cent and 10 per cent of the original are to be cleared in years 3 and 4. The amounts to be written off in these years may be found, thus—

	£	£
Year 3	$\frac{15}{25} \times 50 =$	30
Year 4	$\frac{10}{25} \times 50 =$	20

There is no necessity to work the account back to the commencing figure in ordinary circumstances, but where necessary, the computation can be easily made as follows—

$$\begin{aligned} &\pounds \\ &50 = 25\% \text{ of the original} \\ \therefore\ \tfrac{100}{25} \times\ &50 = \pounds 200 = \text{the original} \end{aligned}$$

Illustration. The Suspense Account at the end of the second year (i.e. after two instalments had been credited to Profit and Loss Account), was £240; the proportions to be written off were—

Year 1, 15%. Year 2, 25%. Year 3, 40%. Year 4, 15%. Year 5, 5%.

As 40 per cent has been written off there remains 60 per cent in three parts (40% + 15% + 5%) to be disposed of. The amounts to be credited to Profit and Loss Account in the three subsequent years therefore are—

		£
Year 3 . . .	$\frac{40}{60} \times \pounds 240 =$	160
Year 4 . . .	$\frac{15}{60} \times \pounds 240 =$	60
Year 5 . . .	$\frac{5}{60} \times \pounds 240 =$	20
		£240

The original sum must have been $\frac{100}{60} \times \pounds 240 = \pounds 400$.

The amounts written off in years 1 and 2 were—

Year 1 . . .	$\frac{15}{100} \times \pounds 400 =$ £ 60,	leaving £340
Year 2 . . .	$\frac{25}{100} \times \pounds 400 =$ £100,	leaving £240
or	$(\frac{25}{85} \times \pounds 340)$	

The Interest Suspense Account may alternatively be written off according to a "progression" method, e.g. in inverse proportion to the years elapsing from the commencement of the instalment period. For instance, if the period is five years, the Interest Suspense Account will be disposed of as follows—

Year 1 . . .	5	i.e. $\frac{5}{15}$
Year 2 . . .	4	,, $\frac{4}{15}$
Year 3 . . .	3	,, $\frac{3}{15}$
Year 4 . . .	2	,, $\frac{2}{15}$
Year 5 . . .	1	,, $\frac{1}{15}$
[*See note page* 492] (*a*)	15	

Illustration. Assuming the Interest Suspense Account was £150,

show the transfers to Profit and Loss Account in the foregoing proportions—

		£
Year 1 . . .	$\frac{5}{15} \times £150 =$	50
Year 2 . . .	$\frac{4}{15} \times £150 =$	40
Year 3 . . .	$\frac{3}{15} \times £150 =$	30
Year 4 . . .	$\frac{2}{15} \times £150 =$	20
Year 5 . . .	$\frac{1}{15} \times £150 =$	10
		£150

If the first payment was made "cash down" at the time of sale, and the duration of the instalment period was consequently reduced to four years, the proportionate amounts of interest to be written off in the four years would be—

			£
Year 1 . . .	4	i.e. $\frac{4}{10} \times £150 =$	60
Year 2 . . .	3	„ $\frac{3}{10} \times £150 =$	45
Year 3 . . .	2	„ $\frac{2}{10} \times £150 =$	30
Year 4 . . .	1	„ $\frac{1}{10} \times £150 =$	15
(*b*)	10		£150

Note: If the sales are taken at an average date of half-way through the accounting period, the proportions will be computed as shown on page 486, thus—

(*a*) $2\frac{1}{2} : 4\frac{1}{2} : 3\frac{1}{2} : 2\frac{1}{2} : 1\frac{1}{2} : \frac{1}{2}$, involving *six* periods.
(*b*) $2 : 3\frac{1}{2} : 2\frac{1}{2} : 1\frac{1}{2} : \frac{1}{2}$, involving *five* periods.

The advantages and disadvantages of the Interest Suspense method are shortly—

Advantages: (1) Provided that suitable provision is made, the true profit is shown in the period of delivery (the transaction being regarded for practical purposes as a sale).

(2) Interest is taken into account and is properly spread over the relevant period.

(3) It is more acceptable for Income Tax purposes.

Disadvantages: (1) Complicated.

(2) Not suitable for transactions of small amount or covering a short period or where agreements differ in rate of interest.

(3) Not suitable for agreements of varying periods.

(4) Provision must be made for Bad Debts and for losses on unfulfilled agreements.

(5) Not suitable for Hire Purchase transactions where an option to settle for cash on reduced terms is exercised with any degree of frequency.

Sales with Hire Purchase Reserve. Small traders often adopt the simple device of making a reserve representing profit on the hire purchase transactions.

Illustration. A, who has a mixed business of the above type, has hire purchase debtors outstanding as follows: 1st January, 19..,

£2,000; 31st December, 19.., £3,500. He treats all hire purchase transactions as sales and creates a 20 per cent hire purchase reserve.

Dr.		HIRE PURCHASE RESERVE					*Cr.*
19..			£	19 .			£
Dec 31	To Balance . . . [20% on £3,500]	c/d	700	Jan. 1	By Balance . . . [20% on £2,000]	b/d	400
				Dec. 31	„ Transfer to Hire Purchase Sales Account		300
			£700				£700
				19.. Jan. 1	By Balance . . .	b/d	700

The Balance Sheet would include on the Assets side—

	£	£
Balances under Hire Purchase Agreement	3,500	
Less Hire Purchase Reserve	700	
		2,800

(B) Goods Out or Stock System—

Method 1—At Cost. The cardinal feature of this system is to consider all the goods out on hire as stock. In order to keep a full record of goods out on hire purchase, it is necessary to have Ledger Accounts of the customers showing the same detail therein as if the goods had actually been sold, but these accounts are not part of the ordinary double entry system; and although the principle of double entry may be employed in balancing the accounts, they are purely MEMORANDA. They supply important information showing what each customer owes, but they form no part of the double entry.

The procedure may be outlined as follows—

(1) Debit Hire Purchase Trading Account and credit Purchases Account with COST price of goods sent to customers on hire purchase. At the same time each Customer's (MEMORANDUM) Account will be debited with the SALE PRICE of such goods.

(2) Returns from customers. (See pages 495 and 506.)

(3) The instalments paid will be debited to cash and credited to Hire Purchase Trading Account. At the same time, the Customer's (MEMORANDUM) Account will be credited.

(4) The instalments due and unpaid will be debited to Instalments Due Account and credited to Hire Purchase Trading Account

(5) The stock "out," i.e. the same proportion of the cost of the goods sent as the amount of unaccrued instalments bears to the total amount of the instalments, is credited to Hire Purchase Trading Account and debited to Hire Purchase Stock Account.

(6) The MEMORANDA accounts will show the balances against the customers, but not being part of the double entry are not brought into the Trial Balance. Thus, the customers' accounts are "reference" accounts only. A transfer may be made similar to that in (4).

The gross profit is the excess of the sum of instalments due and paid, plus stock out on hire purchase at the end of the period over the stock out on hire purchase at the beginning, plus goods sent to customers during the period, less returns, at cost.

Shown in account form—

Dr. HIRE PURCHASE TRADING ACCOUNT *Cr.*

		£			£
To Stock at Cost	b/d		By Instalments Paid		
„ Goods sent to Customers at Cost			„ „ Due		
„ Gross Profit			„ Stock at Cost	c/d	
To Stock at Cost[1]	b/d				

Before illustrating the working of the above a simple example is given to show the computation of the value of the stock out on hire purchase.

Illustration. Goods costing £10 are sent to B on hire purchase, the price being £20, payable in twenty instalments of equal intervals. At the end of the accounting period of the Hire Vendor, five instalments are yet unpaid (fifteen having been paid at due dates).

The stock in the hands of the customer is valued as follows—

$$\frac{5}{20} \times £10 = £2 \text{ 10s.}$$

Assuming, further, that (for sake of simplicity) it is the only transaction of the period, the Hire Purchase Trading Account would appear as follows—

Dr. HIRE PURCHASE TRADING *Cr.*

		£	s.	d.			£	s.	d.
To Goods at Cost		10	0	0	By Instalments Paid		15	0	0
„ Gross Profit		7	10	0	„ Stock		2	10	0
		£17	10	0			£17	10	0

Dr. HIRE PURCHASE STOCK *Cr.*

		£	s.	d.					
To Hire Purchase Trading Account		2	10	0					

In the *Memorandum* Hire Purchase Ledger—

Dr. B *Cr.*

		£	s.	d.			£	s.	d.
To Goods		*20*	*0*	*0*	*By Cash* (*detailed as each payment is made*)		*15*	*0*	*0*
					„ *Balance*	*c/d*	*5*	*0*	*0*
		£20	*0*	*0*			*£20*	*0*	*0*
To Balance	*b/d*	*5*	*0*	*0*					

[1] Or transferred to and from a separate Stock Account.

It should be now quite clear that the balances on the customers' accounts do not appear as part of double entry accounting and hence do not form a part of the Trial Balance. *Practically*, these MEMORANDA Accounts are vital, but from a *double entry* point of view entirely unnecessary, as the Hire Purchase Trading Account gives the necessary results and forms an integral part of the double entry. This point is stressed because of the confusion in the minds of students as to the function of the Memoranda Accounts. Important as the Memoranda Accounts are for reference, they can be ignored in completing the double entry.

The books employed will be the Day Books, the Cash Book, and supplementary to the double entry, the MEMORANDUM Ledger.

The Day Books, as to sales and returns inwards, will usually contain supplementary columns in order to fulfil the functions of the double entry *and* to furnish the necessary data from which may be compiled the MEMORANDA Accounts, i.e. there will be a column for the purpose of the double entry and others recording the detail necessary for the compilation of the MEMORANDA Accounts. Columns in the Sales Day Book, apart from date and folio columns, are usually necessary to record—

(1) Cost price of the goods sold.
(2) Sale price of the goods sold.
(3) Number and amounts of instalments.
(4) Periodicity of instalments.
(5) Any other information that circumstances require.

There will be no difficulty if it is remembered that the first column is for the double entry, the others being for "MEMORANDUM" purposes only, forming no part of the double entry; but column (2) provides the data for entering up the MEMORANDA Accounts. The total of column (1) will be debited to the Hire Purchase Trading Account and credited to Purchases Account, and so far as this side of the transaction is concerned, this is the only double entry. The individual items in column (2) will be posted to the debit of the customers' accounts in the MEMORANDUM Ledger, and these postings are of no account so far as the double entry is concerned. It is usual, however, to total column (2) and post this total to a MEMORANDUM Ledger Adjustment Account, the entries being made in total to the credit, i.e. the opposite side to that to which the individual items are posted.

Returns Inwards (at cost) will be dealt with conversely, i.e. column (1) is totalled and such total is posted to the debit of Purchases Account and to the credit of Hire Purchase Trading Account as part of the ordinary double entry, while the details of returns (at selling price) will be posted from column (2) to the credit of the respective customers' accounts in the MEMORANDUM Ledger, and if a MEMORANDUM Ledger Adjustment Account is employed, the total of column (2) will be posted to the debit of this account.

The other columns call for no special mention as they are self-explanatory. It may here be mentioned that if the accounts of customers are very numerous, a Card Ledger system is frequently employed.

With regard to cash received, the entries will be made in the Cash Book in the usual way, but such entries fulfil a twofold function: (1) for the double entry, (2) for writing up the MEMORANDA Accounts. The total of cash received from hire purchase customers is posted (as part of the double entry) to the credit of Hire Purchase Trading Account, whilst the individual receipts are posted to the credit of the customers' accounts in the MEMORANDUM Ledger. If a MEMORANDUM Ledger Adjustment Account is employed the total of such receipts will be posted to the debit thereof.

The MEMORANDUM Ledger Adjustment Account, when totalled, will have the balance on the opposite side to the detailed balances in the MEMORANDUM Ledger. Thus the system is to adapt the double entry idea in the verification of the MEMORANDUM Ledger total by means of the Adjustment Account, but still it is quite independent of the normal double entry accounting.

Lastly, any instalments actually due and unpaid will be ascertained from the MEMORANDUM Ledger, and these will be credited to the Hire Purchase Trading Account and debited to a separate account called Instalments Due Account. Frequently the latter are ignored for the purpose of the Hire Purchase Trading Account, in which case the cost equivalent of the unpaid instalments will be included in stock.

The balance of the Hire Purchase Trading Account will be transferred to the Trading Account, subject to suitable provision for losses, depreciation, and the like.

Illustration. Easy Payments, Ltd., forwards a piano to A on the hire purchase system, the cost being £100 and the selling price £200; payable in fifty monthly instalments of £4 each, commencing on 31st August. The sale takes place on 31st August, 19.. ; the instalments are regularly paid. Accounts are drawn up to 31st December, 19...

On 1st October, 19.., a similar sale is made to B, the cost price being £78, the sale price £104 payable in weekly instalments of £2, commencing on 1st October; the instalments are paid regularly. Show the various entries necessary in the books of the Hire Vendor.

HIRE VENDOR'S BOOKS—

HIRE PURCHASE SALES DAY BOOK

Date	Particulars	No. of Instalments	Period of Instalments	Amount of Instalment	Cost Price	Fol.	*Selling Price*
19..				£	£		£
Aug. 31	A	50	monthly	4	100	*1*	*200*
Oct. 1	B	52	weekly	2	78	*2*	*104*
					£178		*£304*

The total of the cost price column (as part of the double entry) is posted to the debit of the Hire Purchase Trading Account. If such an account is to be drawn up to 31st December, 19.., the cash received and the value of the stock in the hands of customers will be found as follows—

(1) Cash received from—

A—£20, i.e. 5 payments of £4. B—£28, i.e. 14 payments of £2.

(2) Stock "out"—

Instalments outstanding × COST

$$A = \tfrac{45}{50} \times £100 = 90$$
$$B = \tfrac{38}{52} \times £\ 78 = \underline{57}$$
$$£147$$

Ordinarily, *in practice*, a Schedule will be prepared for the purpose of arriving at the valuation of the hire purchase stock out, thus—

HIRE PURCHASE STOCK SCHEDULE

Contract No.	Name	No. of Instalments	No. of Instalments: Paid	Unpaid	Cost Price £	s.	d.	Proportion of Cost Price £
1	A	50	5	45	100	0	0	90
2	B	52	14	38	78	0	0	57
				£	178	0	0	£147[1]

[1] The end column shows the hire purchase stock "out," the total of which is incorporated into the Double Entry Accounts, as below—

Dr HIRE PURCHASE TRADING ACCOUNT *Cr.*

		£			£
To Goods at Cost (*Cr. Purchases*) . .		178	By Instalments Paid (*Dr. Cash*) . .		48
,, Gross Profit transferred to Trading Account .		17	,, Stock (as above)[1] .	c/d	147
		£195			£195
To Balance—Stock. .	b/d	147			

[1] Or transferred to Hire Purchase Stock Account.

The separate instalments of cash, detailed above, will be entered in the Cash Book (in practice a separate subsidiary Cash Book will be employed). The debit entry will thus occur in the Cash Book, the totals (daily, weekly, monthly, as required) of which will be credited to the Hire Purchase Trading Account. In this case £48 is the sum to be so treated.

The above entries complete the formal double entry, but entries are also made in respect of cash received in the MEMORANDUM

Books. The individual items in the Selling price column of the Hire Purchase Sales Day Book will be debited to the Personal Accounts in the MEMORANDUM Ledger and the total will be posted to the credit of the MEMORANDUM Ledger Adjustment Account, if one be employed.

The cash received will be posted in individual items, as recorded in the Cash Book, to the credit of the individual accounts in the MEMORANDUM Ledger, and in total to the debit of the MEMORANDUM Ledger Adjustment Account.

No. 1 MEMORANDUM HIRE PURCHASE LEDGER

Dr. A Cr.

19..			£	19..			£
Aug. 31	To Goods		200	Dec. 31	By Cash		20
					" Balance	c/d	180
			£200				£200
19..							
Jan. 1	To Balance	b/d	180				

No. 2

Dr. Cr.

19..			£	19..			£
Oct. 1	To Goods		104	Dec. 31	By Cash		28
					" Balance	c/d	76
			£104				£104
19..							
Jan. 1	To Balance	b/d	76				

It is again emphasized that the Cash Book fulfils the dual function (*a*) of supplying the double entry, and (*b*) of supplementing the MEMORANDA Accounts, which are completely outside the double entry.

Goods Out or Stock System—Method 2—At Selling Price. An alternative method to that already outlined is to debit the goods out on hire at selling prices. If the method of dealing with goods sent to branches at selling price is thoroughly understood, no difficulty arises. The goods out with customers are treated, as far as the double entry books are concerned, exactly like goods sent to branches; thus it is merely necessary to use the correct heading, i.e. Hire Purchase Stock Account instead of Branch Stock Account. An advantage accruing to this method is that the sundry debtors (in total) will be in agreement with the actual debtor balances, thus enabling the individual accounts to be linked up with the double entry.

Illustration. A, Ltd., which sells a patent product on hire purchase terms, has the following transactions for the year to 31st December, 19... The gross profit is 25 per cent on selling price—

19		£
Jan. 1.	Stock out on Hire at Hire Purchase price	4,000
	Stock on hand (in the shop)	500
	Instalments due (customers still paying)	300
Dec. 31.	Stock out on Hire at Hire Purchase price	4,600
	Stock on hand (in the shop)	700
	Instalments due	500
	Cash received in Instalments during the year	8,000

To prepare the Trading Account for the year to 31st December, 19.., the following accounts are necessary—

Dr. SUNDRY DEBTORS *Cr.*

19			£	19			£
Jan. 1	To Balances	b/d	300	Dec. 31	By Cash		8,000
Dec. 31	" Sales		8,200		" Balances	c/d	500
			£8,500				£8,500
19							
Jan. 1	To Balances	b/d	500				

Dr. HIRE PURCHASE STOCK *Cr.*

19			£	19			£
Jan 1	To Balance[1]	b/d	4,000	Dec. 31	By Sales for Year		8,200
Dec 31	" Goods on Hire Purchase Account		8,800		" Stock	c/d	4,600
			£12,800				£12,800
19							
Jan. 1	To Balance	b/d	4,600				

Dr. SHOP STOCK *Cr.*

19			£	19			£
Jan 1	To Balance	b/d	500	Dec 31	By Goods on Hire Purchase Account (at cost)		6,600
Dec 31	" Purchases		6,800		" Balance	c/d	700
			£7,300				£7,300
19							
Jan 1	To Balance	b/d	700				

Dr GOODS ON HIRE PURCHASE *Cr.*

19			£	19			£
Dec 31	To Shop Stock Account		6,600	Dec 31	By Hire Purchase Stock Account		8,800
	" Hire Purchase Adjustment Account (loading)		2,200				
			£8,800				£8,800

Dr. HIRE PURCHASE ADJUSTMENT ACCOUNT *Cr.*

19			£	19			£
Dec 31	To Gross Profit to Profit and Loss Account		2,050	Jan 1	By Balance[1] [25% on £4,000]	b/d	1,000
	" Provision [25% on £4,600]	c/d	1,150	Dec 31	" Goods on Hire Purchase Account		2,200
			£3,200				£3,200
				19			
				Jan 1	By Provision	b/d	1,150

The Sales are found after writing up the Sundry Debtors Account.

[1] Opening stock at cost is, therefore, £3,000

The balances on the Memoranda Accounts will equal in total the balance brought down on the Sundry Debtors Account.

In the Balance Sheet the items will appear as follows at 31st December, 19..—

	£	£
Stock out on Hire Purchase .	4,600	
Less Provision . . .	1,150	
		3,450
Stock on hand		700

If memorandum columns (Double Column Method, see page 421) are used, the two following accounts will appear instead of the corresponding accounts on page 499, the Stock being brought down at cost, thus dispensing with the Hire Purchase Adjustment Account.

Dr HIRE PURCHASE STOCK Cr.

			Memo. £	£				*Memo.* £	£
19.. Jan. 1	To Balance .	b/d	4,000	3,000	19.. Dec. 31	By Sales for year .		8,200	8,200
Dec. 31	„ Goods on Hire Purchase		8,800	6,600		„ Stock .		4,600	3,450
	„ Gross Profit .			2,050					
			£12,800	£11,650				£12,800	£11,650
19.. Jan. 1	To Balance .	b/d	4,600	3,450					

Dr. GOODS ON HIRE PURCHASE Cr.

		£			£
19.. Dec. 31	To Shop Stock . .	6,600	19.. Dec. 31	By Hire Purchase Stock	6,600

If it is practicable to adopt these methods (e.g. where there is a uniformity of rate of gross profit) the accounts will be, *mutatis mutandis*, on the same lines as Branch Accounts; and the result will be similar to the preceding method. This will now be illustrated, and a comparison between the Selling price and Cost price methods will be shown.

Illustration. X, Ltd., sells goods to A for £150 and to B for £100; the gross profit being 20 per cent on selling price (i.e. 25 per cent on cost price). A is to pay six instalments of £25 each and B ten instalments of £10 each. At the end of the accounting period A has paid two and B five instalments. B is in arrear for one instalment.

(*a*) The "Branch" method at *selling price*—

Dr. HIRE PURCHASE STOCK Cr.

			£				£
	To Sundries per Day Book		250		By Cash . . .		100
					„ Instalments Due Account . .		10
					„ Balance . . .	c/d	140
			£250				£250
	To Balance . . .	b/d	140				

Dr. **Stock** *Cr.*

					£
			By Goods on Hire Purchase Account .		200

Dr. **Hire Purchase Adjustment Account** *Cr.*

		£			£
To Gross Profit to Profit and Loss Account .		22	By Goods on Hire Purchase Account .		50
„ Provision . . .	c/d	28			
		£50			£50
			By Provision . .	b/d	28

Dr. **Instalments Due** *Cr.*

		£			
To Hire Purchase Stock		10			

The Personal Accounts in the Memorandum Hire Purchase Ledger, which should agree with the balance of Hire Purchase Stock Account, are as follows—

Dr. A *Cr.*

		£			£
To Goods . .		150	By Cash . . .		50
			„ Balance . . .	c/d	100
		£150			£150
To Balance . .	b/d	100			

Dr. *Cr.*

		£			£
To Goods . . .		100	By Cash . . .		50
			„ Transfer to Instalments Due Account		10
			„ Balance . . .	c/d	40
		£100			£100
To Balance . . .	b/d	40			

The stock at selling price must be reduced to cost price by means of a provision in the Hire Purchase Adjustment Account, i.e. $\frac{1}{5} \times £140 = £28$, leaving the amount of stock to be shown in the Balance Sheet as $£140 - 28 = £112$.

The latter figure is proved by employing the rule of proportion shown on page 494, i.e.—

	£
A—$\frac{4}{6}$ × £120 (cost price of £150) =	80
B—$\frac{4}{10}$ × £ 80 (cost price of £100) =	32
	£112

(β) The "Branch" method at *cost price*—

If this method be employed, the MEMORANDA Accounts will be unaltered, and the Hire Purchase Trading Account will appear—

Dr. HIRE PURCHASE TRADING ACCOUNT *Cr.*

		£			£
To Goods . . .		200	By Instalments Paid .		100
„ Gross Profit to Profit and Loss Account .		22	„ Instalments Due Account . . .		10
			„ Stock . . .	c/d	112
		£222			£222
To Stock . .	b/d	112			

If the Double Column method is used, the Trading Account will be—

Dr. HIRE PURCHASE TRADING ACCOUNT *Cr.*

			Memo. Selling Price				Memo. Selling Price
		£	£			£	£
To Goods . .		200	250	By Cash . .		100	100
„ Gross Profit to Profit and Loss Account		22		„ Debtors .		10	10
				„ Stock (at cost)	c/d	112	
				„ „ (at selling)	c/d		140
		£222	£250			£222	£250
To Stock . .	b/d	112	140				

In this case the selling price columns are purely MEMORANDA, the full double entry being effected from the inner columns.

The advantages and disadvantages of the Goods Out or Stock system are shortly—

Advantages: (1) Simplicity.

(2) Convenience in regard to transactions which are small or varying in amount or period.

(3) Profit is taken as earned only when instalments are paid or become due, thus providing for future losses on unfulfilled agreements.

(4) The balance of goods for which payment is not yet due can easily be reduced to market value if lower than cost.

(5) Where profit is taken only when instalments have been paid, no provision for Bad Debts is required.

Disadvantages: (1) Difficulties with Income Tax assessment.

(2) Over-cautious and not reflective of the true yearly profit.

(3) Interest is not taken into account.

Summary of Hire Vendor's Accounts. No particular difficulty is encountered in dealing with the books of the hire purchaser. On the other hand, students generally experience considerable trouble in writing up the books of the hire vendor. It will therefore be advisable to summarize the methods dealt with in reference to the hire vendor.

The methods are—

(1) **Sales Methods—**

(*a*) Ordinary sale (inclusive of interest).

(*b*) Ordinary sale (exclusive of interest) and charging interest separately either (i) as it arises or (ii) by crediting a Suspense for the full amount and writing off a proportionate amount yearly to the credit of Profit and Loss Account.

(*c*) Ordinary sale (exclusive of interest) and raising an Interest Suspense Account.

(*d*) Ordinary sale (inclusive of interest) and creating a Hire Purchase Reserve for unearned profit.

(*e*) Ordinary sale but apportioning profit as well as interest.

(2) **Goods Out or Stock Methods—**

(*a*) *At cost.*

(*b*) *At selling price.*

The two methods of paramount importance which must be known thoroughly are—

(1) Sale method whereby the profit is taken in the year of the transaction, with the employment of an Interest Suspense Account whereby interest is spread over the period of the agreement. (Method 1*c*.)

(2) Goods out or Stock method whereby profit is taken in relation to instalments actually received, interest generally being ignored. (Method 2*a*.)

The remaining methods are usually adopted only in abnormal circumstances.

General Illustration. Below are given five different methods of dealing with Hire Purchase transactions in the books of the seller—

(1) The buyer is debited with the *cash* price when the agreement is made. The hire charge is periodically debited to him, so that at the end of each year the amount so charged corresponds with the number of instalments paid (excluding deposits), and credited to Interest Account.

(2) The buyer is debited with the Hire Purchase price, the excess of which over the cash price is credited to Interest Suspense Account and cleared to Profit and Loss Account only when the transaction is completed.

(3) A Hire Purchase Trading Account is debited with the cost price of the goods delivered on Hire Purchase and credited with the total of deposits and instalments received during the period. The Hire Purchase Trading Account is credited, at the end of each year, with the proportion of the cost price of the goods sent out on Hire Purchase, which the amount of instalments outstanding bears to the total amount of instalments (and deposits) arising on each transaction. The balance on the account is considered profit on Hire Purchase Trading.

(4) A Hire Purchase Trading Account is dealt with as in (3), except that at the end of the year the account is credited with the instalments still outstanding, reduced to cost.

(5) The same method is employed as in (4), except that the closing credit is computed on the basis of the full amounts outstanding on Hire Purchase transactions, less a general provision of 25 per cent.

Show how, in the seller's books, the profit for the year 19.. arising out of the undermentioned transactions would differ in each of the above methods, assuming that

(*a*) instalments are regularly paid,

(*b*) sales all took place on 1st January, 19.., and that

(*c*) instalments are payable monthly, commencing 31st January, 19...

Hire Purchaser	A	B	C	Total
	£	£	£	£
Cost Price	80	100	30	210
Hire-purchase Price	110	130	59	299
Cash Price	100	120	45	265
Deposit	10	20	5	
Number of Instalments	10	22	18	
Amount of each Instalment	10	5	3	

(1)

	Profit on Cash Price		*Interest*	*Total Profit 19..*
	£		£ s. d.	£ s. d.
A	20		10 0 0	30 0 0
B	20	12/22 × £10	5 9 1	25 9 1
C	15	12/18 × £14	9 6 8	24 6 8
	£55		£24 15 9	£79 15 9

The profit on the whole completed transactions would be £299 less £210 = £89. This is reconciled with the profit shown above as follows—

		£ s. d.	£ s. d.
Total Profit on the whole transactions			89 0 0
Less Credit not taken for Interest—			
B	$\frac{10}{22}$ × £10	4 10 11	
C	$\frac{6}{18}$ × £14	4 13 4	
			9 4 3
			£79 15 9

(2)

	Profit on Cash Price	*Interest*	*Total Profit 19..*
	£	£	£
A	20	10	30
B	20		20
C	15		15
	£55	£10	£65

None of the interest for B and C (£24) is credited, thus accounting for the difference between the profit on the whole completed transactions (£89) and the £65 shown above.

(3)

				£	s.	d.
Deposits received				35	0	0
Instalments received—						
A . . .	10 × £10 =	£100				
B . . .	12 × £5 =	60				
C . . .	12 × £3 =	36		196	0	0
				231	0	0

Add Hire-purchase goods reduced to cost—

		£	s.	d.
B .	$\frac{10 \times 5}{20 + (22 \times 5)} = \frac{50}{130} \times £100 =$	38	9	3
C .	$\frac{6 \times 3}{5 + (18 \times 3)} = \frac{18}{59} \times £30 =$	9	3	0

	£	s.	d.
	47	12	3
	278	12	3
Less Cost Price of goods .	210	0	0
Total Profit 19.. . .	£68	12	3

Reconciliation with total profit on completed transactions of £89 is—

	£	s.	d.	£	s.	d.
Profit as above				68	12	3
Add instalments outstanding—						
B	50	0	0			
C	18	0	0			
	68	0	0			
Less credited above as stock at cost	47	12	3	20	7	9
				£89	0	0

(4) As (3).

Methods (3) and (4) are identical because the denominator, used in the calculation in (3) to reduce the outstanding goods to cost, of "Total instalments and deposits" is the same as that used in (4) of "Hire-purchase Price," as the latter must equal "Total instalments and deposits."

	£	s.	d.	£	s.	d.
(5) Deposits and instalments received as in (3) above . .				231	0	0
Add amounts outstanding—						
B	50	0	0			
C	18	0	0			
	68	0	0			
Less 25% Provision . .	17	0	0	51	0	0
				282	0	0
Less Cost Price of goods .				210	0	0
Total Profit 19.. . .				£72	0	0

Profit as shown £72, plus the provision of £17, equals the profit on the whole completed transactions of £89.

Returns. Although of great importance in practice, this section of the subject is relatively unimportant from the examination aspect, and the subjoined illustrations will suffice to enable the student to become familiar with the type of problem likely to be met with in the examination hall.

Illustration. The balance due by hire purchaser at the date of default is £1,000. The goods are seized by the hire vendor, who agrees to allow the purchaser to pay £200 to close the account. The goods are revalued at £450. Subsequently, expenses are incurred thereon to the extent of £75 and the goods sold for cash £617. Show accounts in the hire vendor's books, employing the ordinary sale method. Ignore interest.

HIRE VENDOR'S BOOKS—

Dr. HIRE PURCHASER *Cr.*

			£			£
	To Balance	b/d	1,000		By Cash	200
					" Hire Purchase Returns Account	800

Dr. HIRE PURCHASE RETURNS *Cr.*

			£			£
	To Hire Purchaser		800		By Returned Hire Purchase Trading Account	450
					" Loss on Returned Hire Purchase Goods Account	350

Dr. CASH (*includes*) *Cr.*

			£			£
	To Hire Purchaser		200		By Expenses on Returned Hire Purchase Goods	75
	" Sale of Returned Hire Purchase Goods		617			

Dr. RETURNED HIRE PURCHASE TRADING ACCOUNT *Cr.*

			£			£
	To Hire Purchase Returns Account		450		By Sales (Cash)	617
	" Expenses		75			
	" Profit and Loss on Sale of Returned Hire Purchase Goods Account		92			
			£617			£617

Dr. LOSS ON RETURNED HIRE PURCHASE GOODS *Cr.*

			£			
	To Hire Purchase Returns Account		350			

Dr. PROFIT AND LOSS ON SALE OF RETURNED HIRE PURCHASE GOODS *Cr*

						£
					By Returned Hire Purchase Trading Account	92

Ignoring interest, the vendor would in due course have received £1,000. His receipts are, however, £817, less £75 = £742, thus disclosing a net loss of £258, which is explained by—

	£
(1) Loss on Returned Goods	350
(2) *Less* Profit on Resale	92
Net Loss	£258

Illustration. On 1st January, 19.., A agrees to acquire furnishings on the hire purchase system, agreeing to pay four half-yearly instalments of £400 each, commencing on 30th June, 19... Interest at 5 per cent per annum on cash price of £1,505.

On 30th September, 19.., A defaulted and the hire vendor seized the property. It is agreed that A should pay the due proportion of his half-yearly instalment, £200, and £180 for depreciation of the furnishings. The returned goods are revalued at £600.

The furnishings were resold on 15th November, 19.., for £920 after renovating expenses had been paid of £150 on 31st October.

Show the accounts in the hire vendor's books, assuming that he passes hire purchase transactions through the books as sales.

[The student should realize that the problem is one that is divisible into four main parts, viz.—

(1) The hire purchase transaction and payments.

(2) The return of the goods and adjustment of the balance of the Hire Purchaser's Account.

(3) Loss arising from revaluation of the returned goods.

(4) The subsequent sale of the returned goods after any necessary expenditure has been incurred.]

Hire Vendor's Books—

Dr. A (Hire Purchaser) *Cr.*

			£	s.	d.				£	s.	d.
19..						19..					
Jan. 1	To Furnishings .		1,505	0	0	June 30	By Cash . .		400	0	0
June 30	,, Interest at 5% p.a. on £1,505 for ½ year .		37	12	6	Sept. 30	,, ,, . .		200	0	0
Sept. 30	,, Interest at 5% p.a. on £1,142 12s. 6d. for 3 months .	[1]	14	5	8		,, ,, re Depreciation .		180	0	0
							,, Hire Purchase Returns Account . .		776	18	2
			£1,556	18	2				£1,556	18	2

Dr. Hire Purchase Returns *Cr.*

			£	s.	d.				£	s.	d.
19..						19..					
Sept. 30	To A		776	18	2	Sept. 30	By Hire Purchase Returns Trading Account .		600	0	0
							,, Loss on Returned Hire Purchase Goods Account		176	18	2
			£776	18	2				£776	18	2

[1] I.e. £1,505 plus £37 12s. 6d., less £400.

Dr. HIRE PURCHASE SALES Cr.

			£	s.	d.				£	s.	d.
						19.. Jan. 1	By A . . .		1,505	0	0

Dr. HIRE PURCHASE INTEREST Cr.

			£	s.	d.				£	s.	d.
						19.. June 30	By A . . .		37	12	6
						Sept 30	,, ,, . . .		14	5	8

Dr. CASH (*includes*) Cr.

			£	s.	d.				£	s.	d.
19.. June 30	To A . . .		400	0	0	19.. Oct. 31	By Expenses on Returned Hire Purchase Goods .		150	0	0
Sept. 30	,, ,, . . .		200	0	0						
	,, ,, . . .		180	0	0						
Nov. 15	,, Sale of Hire Purchase Returns		920	0	0						

Dr. HIRE PURCHASE RETURNS TRADING ACCOUNT Cr.

			£	s.	d.				£	s.	d.
19.. Sept. 30	To Hire Purchase Returns Account		600	0	0	19.. Nov. 15	By Cash . .		920	0	0
Oct. 31	,, Expenses . .		150	0	0						
Nov. 15	,, Profit on Resale .		170	0	0						
			£920	0	0				£920	0	0

Dr. LOSS ON RETURNED HIRE PURCHASE GOODS Cr.

			£	s.	d.				£	s.	d.
19.. Sept. 30	To Hire Purchase Returns Account		176	18	2						

Dr. PROFIT AND LOSS ON SALE OF RETURNED HIRE PURCHASE GOODS Cr.

			£	s.	d.				£	s.	d.
						19.. Nov. 15	By Hire Purchase Returns Trading Account .		170	0	0

The whole position may be summarized, showing the profit on the transaction, and for this purpose the goods will be taken as costing the hire vendor £1,000.

		£	s.	d
Goods Cost	£1,000			
Profit on Hire Purchase Sale		505	0	0
Loss on Return		176	18	2
		328	1	10
Profit on Re-sale		170	0	0
		498	1	10
Hire Purchase Interest		51	18	2
Net Profit		£550	0	0
Net Cash received per Cash Book		1,550	0	0
Less Cost of Goods Sold		1,000	0	0
Net Profit [as above]		£550	0	0

POST-SALE SERVICES

Where the transaction carries an obligation on the part of the vendor or hire vendor to perform services subsequent to the transfer of the goods, e.g. to repair and maintain, it is obvious that the cost of such services will be "loaded" on to the price, so that the excess of the price of the goods carrying such an obligation over an ordinary transaction represents the advance payment by the consumer in respect of those future services. Experience must guide the vendor in estimating such loading, always bearing in mind competitive prices; but whatever be the loading, its apportionment is required, depending upon the duration of the service obligation. Where the duration is lengthy, a Suspense Account will be opened to cover all the separate years, against which will be debited the annual cost of effecting the agreed services. There are many services that may be fairly accurately computed, e.g. replacement of gas mantles, quarterly tuning of pianos, but generally the cost will tend to increase each year, so that the Suspense Account should have allocated to it a smaller percentage in the early years than in the later.

The expenses actually incurred in performing the service will be debited (in the year in which they occur) to the appropriate Suspense Account.

Except in fortuitous circumstances, such suspense accounts will never balance, that is, the allocation of the loading included in sale or hire purchase price will not be exactly equal to the service cost. Hence, there will either be a debit or a credit balance, representing respectively a deficiency or a surplus on the loading. In other words, in the instance of a debit balance the service cost exceeds the amount credited to Suspense (included in sale price), whilst a credit balance shows that the service cost has been less than the amount credited to Suspense.

Although it is prudent to write off the debit balance, yet if there have been credit balances arising in previous years and not credited to Profit and Loss Account, a debit balance may be set off against the credit balance in question, and, therefore, so long as a credit balance exists on the Suspense Accounts, any subsequent debit balance thereon may be written off against it; any unabsorbed debit balance of Suspense Account being transferred to Trading or Profit and Loss Account.

Where there is a debit balance on Suspense Account it theoretically results from an incorrect estimate of service cost so that future prices may have to be adjusted accordingly (if competition will permit!). On the other hand the discrepancy may be purely accidental and/or temporary. If, for instance, the general price level has increased, the service costs will be incurred in terms of such enhanced level, so that a loss will be likely to arise as the sales would normally have been based on the lower price levels ruling at the date of the Hire Purchase transaction.

Again, such "deficiency" may be deliberate, and therefore may be considered as a selling expense—advertising, in fact—just in the same way as several chain stores run cafés (charging comparatively low prices) at a loss; but such a policy attracts customers who will probably look round the stores and make purchases.

Illustration. Wireless, Ltd., manufactures a radio set for £12 and sells both outright and on hire purchase. The respective prices are £20 outright and £27 hire purchase—under the latter, payments to be made in four equal half-yearly instalments of £6 15s., the first being payable at the end of the half-year after sale. The company agrees to maintain *all* sets delivered for a period of two years free of charge. From experience the cost of maintenance per set is estimated at £4 (£1 10s. incurred in the first year). Show entries, assuming—

(1) The "pure" sales of sets are 120 per annum.
(2) The hire purchase sales of sets are 300 per annum.
(3) The actual cost of maintenance in the first year was £215.
(4) The sales are uniformly maintained.

The double entry involved is[1]—

(1) Debit Cash £20. Credit Sales £20.
(2) Debit Hire Purchase Debtors £27.
Credit Sales (for sale price) £20.
Credit Interest Suspense £7.
(3) Debit Sales £4. Credit Maintenance Suspense £4.
(4) Debit Maintenance Suspense. Credit Cash (for actual cost).
(5) The balance on the Maintenance Suspense Account will be written off—

(*a*) If Debit—
Debit Trading Account (or Reserve if a surplus arising in past years has been carried forward).
Credit Maintenance Suspense Account.

(*b*) If Credit—
Debit Maintenance Suspense Account.
Credit Reserve.

Computations. It is necessary first to compute two loadings, viz. maintenance and interest.

The loading for maintenance is contained in ALL sales, Cash or Hire Purchase, and is $\frac{4}{20} \times 100\% = 20\%$; this must now be apportioned over the two separate years in the light of experience, which in the question is—

1st year . . .	£1 10 0	i.e. $\frac{1\frac{1}{2}}{20} \times 100\% = 7\frac{1}{2}\%$
2nd year . . .	£2 10 0	i.e. $\frac{2\frac{1}{2}}{20} \times 100\% = 12\frac{1}{2}\%$

[1] The figures show the appropriate amounts for the sale of one set.

But as sales may be taken as being made at an average date of half-way through the financial year, the maintenance will accordingly be split and affect three financial periods, thus—

		%	%
1st year	$\frac{1}{2} \times 7\frac{1}{2}\%$		$= 3\frac{3}{4}$
2nd year	$\frac{1}{2} \times 7\frac{1}{2}\% = 3\frac{3}{4}$		
	$\frac{1}{2} \times 12\frac{1}{2}\% = 6\frac{1}{4}$	$= 10$	
3rd year	$\frac{1}{2} \times 12\frac{1}{2}\%$		$= 6\frac{1}{4}$
			20%

This percentage applies to ALL the transactions based upon the "pure" sales figures, viz—

	Sets	£	£
Pure Sales	120 ×	20 =	2,400
Hire Purchase Sales	300 ×	20 =	6,000
			£8,400

The loading for maintenance is therefore—

		£	£
$3\frac{3}{4}\%$	×	8,400 =	315
10%	×	8,400 =	840
$6\frac{1}{4}\%$	×	8,400 =	525
20%	×	£8,400 =	£1,680

Alternatively, the loading may be computed thus—

		£ s. d	£ s d	£ s. d	£
1st year maintenance per set	$\frac{1}{2}$ ×	1 10 0		15 0 × 420 =	315
2nd year " "	$\frac{1}{2}$ ×	1 10 0	15 0		
	+ $\frac{1}{2}$ ×	2 10 0	1 5 0	2 0 0 × 420 =	840
3rd year " "	$\frac{1}{2}$ ×	2 10 0		1 5 0 × 420 =	525
[See page 513]					£1,680

These figures now form the basis of the entry to the credit of Maintenance Suspense Account, leaving the Hire Purchase Interest Suspense on hire purchase sales to be dealt with.

In both instances the loading for maintenance being segregated, attention must now be given to the loading of £7 for interest on the hire purchase transactions. The net selling price for cash *without* maintenance is £16 per set, but the interest should be calculated upon the amount of £20, not £16, because, as compared with the cash purchasers who pay the £4 *at once* for maintenance the hire purchasers are paying in instalments, hence the £4 must be regarded in the light of a loan. The vendors are obviously deprived of the immediate sum of £4 per set when they permit it to be paid over in instalments.

Therefore the sum of £27 is paid in instalments as against £20 at once, so that the interest is £7 per set.

Assuming the sales (on hire purchase) to take place at the commencement of the year, the interest would be—

			£ s. d	£ s d
Year 1 .	(approx.)	½ yr	2 12 10	
		½ yr.	2 1 11	
				4 14 9
Year 2 .	(approx)	½ yr	1 9 7	
		½ yr	15 8	
				2 5 3
		Total . .		£7 0 0

Averaging these on the basis of sales at an average date of half way through the period, the interest is—

		£ s d	£ s d	£ s d
Year 1.	½ ×	4 14 9		2 7 4
Year 2.	½ ×	4 14 9	2 7 5	
	½ ×	2 5 3	1 2 7	
				3 10 0
Year 3.	½ ×	2 5 3		1 2 8
		Total . .		£7 0 0

Total interest, therefore, is 300 × £7 = £2,100, apportioned as follows—

		£
Year 1.	$\dfrac{2\ 7\ 4}{7\ 0\ 0} \times 2{,}100 =$	710
Year 2.	$\dfrac{3\ 10\ 0}{7\ 0\ 0} \times 2{,}100 =$	1,050
Year 3.	$\dfrac{1\ 2\ 8}{7\ 0\ 0} \times 2{,}100 =$	340
[See page 513]		£2,100

Alternatively, calculated in terms of sets delivered under hire purchase agreements—

		£ s d	£
Year 1.	300 ×	2 7 4 =	710
Year 2	300 ×	3 10 0 =	1,050
Year 3.	300 ×	1 2 8 =	340
			£2,100

Calculation—

	Balance				Interest			Total			Instalment			Balance		
	£	s	d		£	s	d	£	s	d	£	s	d	£	s	d
Year 1—½ year .	20	0	0		2	12	10	22	12	10	6	15	0	15	17	10
½ year .	15	17	10		2	1	11	17	19	9	6	15	0	11	4	9
Year 2—½ year .	11	4	9		1	9	7	12	14	4	6	15	0	5	19	4
½ year	5	19	4			15	8	6	15	0	6	15	0			
					£7	0	0									

Alternative calculation—

Where the calculation is based upon £16 (instead of £20), the proportions are as below. (The difference between this and the preceding method is negligible.)

	Balance £	s.	d.	Interest £	s.	d.	Total £	s.	d.	Instalment £	s.	d.	Balance £	s.	d.
Year 1—½ year .	16	0	0	2	12	5	18	12	5	5	15	0	12	17	5
½ year .	12	17	5	2	1	10	14	19	3	5	15	0	9	4	3
Year 2—½ year .	9	4	3	1	9	10	10	14	1	5	15	0	4	19	1
½ year .	4	19	1		15	11	5	15	0	5	15	0			
				£7	0	0									

The full entries may now be shown—

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		£ s. d.	£ s. d.
Cash	Dr.	2,400 0 0	
To Sales			2,400 0 0
Being sales outright of 120 Radio sets.			
Hire Purchase Debtors . .	Dr.	8,100 0 0	
To Sales			6,000 0 0
,, Interest Suspense—			
Year 1			710 0 0
,, 2			1,050 0 0
,, 3			340 0 0
Being deliveries under hire purchase agreements and interest allocations, in respect of 300 Radio Sets.			
Sales	Dr.	1,680 0 0	
To Maintenance Suspense —			
Year 1			315 0 0
,, 2			840 0 0
,, 3			525 0 0
Being proportion of estimated maintenance chargeable in the relevant years.			

The cost of maintenance in the first year of £215 will be debited against the item of £315, leaving a balance of £100, which will be credited to Reserve.

HIRE PURCHASER'S BOOKS

The various methods of recording hire purchase transactions in the books of the hire vendor having been separately explained in the earlier pages of this chapter, the methods of recording such transactions in the books of the hire purchaser will now be dealt with.

Separation has been effected in order to preclude any possibility of confusion arising in the mind of the student, and so that the comparatively simple entries required in the books of the hire purchaser may be readily grasped.

There are, of course, more methods of record than it is found expedient to set out here, and of them three of the more important are explained on the next page—

(1) (*a*) Debit the asset with the cash value and credit the Hire Vendor (as if it were an outright purchase).

(*b*) Debit Interest and credit Hire Vendor for Interest at due dates.

(*c*) Debit Hire Vendor and credit Cash with each payment.

(2) Similarly as (1), except the Hire Vendor is credited with the *total of instalments*, i.e. cash price and interest, in which case the amount representing interest will be debited to Interest Suspense Account. No further credits will be then given to Hire Vendor as he has already been credited with the inclusive figure. The Interest Suspense Account will be credited with the proportion of interest allocable to the year in question, this being debited to Interest Account; the cash payment to the Hire Vendor is debited to his account and credited to Cash in the ordinary way, as 1 (*c*) above.

(3) No entry is made until the payment to the Hire Vendor is made, whereupon such sum is allocated between the cost of the asset and interest, the respective proportions being respectively debited to Asset and Interest, the Hire Vendor being credited with the amount of instalment due.

The question of Depreciation will be dealt with on page 516.

Illustration. B buys Machinery on the hire purchase system from A—cash price, £1,000—agreeing to pay for it in two half-yearly instalments with interest at 5 per cent per annum (the interest to be paid each half-year in addition to the amount due on the machinery).

Method 1. The entries in the Hire Purchaser's books for the above illustration will be—

Dr. A *Cr.*

			£	s	d.				£	s.	d.
Half Year 1	To Cash . . .		525	0	0	Half Year 1	By Machinery .		1,000	0	0
	,, Balance . .	c/d	500	0	0		,, Half year's Interest on £1,000 at 5% per annum .		25	0	0
			£1,025	0	0				£1,025	0	0
Half Year 2	To Cash .		512	10	0	Half Year 2	By Balance . .	b/d	500	0	0
							,, Half year's Interest on £500 at 5% per annum .		12	10	0
			£512	10	0				£512	10	0

Dr. MACHINERY *Cr.*

			£	s.	d.						
Half Year 1	To A		1,000	0	0						

Where the Hire Purchaser pays equal instalments to cover principal and interest, the account of the Hire Vendor, in the Hire Purchaser's books, will be reverse of that appearing in the books of the former.

Illustration. Assuming the facts used in the illustration on page 482 (second illustration), the entries in the books of the Hire Purchaser relative to the Hire Vendor will be—

Dr. **A** **Cr.**

			£	s.	d.				£	s.	d.
Half Year 1	To Cash . . .		518	16	6	Half Year 1	By Machinery .		1,000	0	0
	,, Balance . .	c/d	506	3	6		,, Half year's Interest on £1,000 at 5% per annum .		25	0	0
			£1,025	0	0				£1,025	0	0
Half Year 2	To Cash . .		518	16	7	Half Year 2	By Balance . .	b/d	506	3	6
							,, Half year's Interest on £506 3s. 6d. at 5% per annum .		12	13	1
			£518	16	7				£518	16	7

See also page 483 for entries in Hire Vendor's Books.

Method 2—

Dr. **MACHINERY** **Cr.**

			£	s.	d.				£	s.	d.
Half Year 1	To Hire Vendor .		1,000	0	0						

Dr. **INTEREST SUSPENSE** **Cr.**

			£	s.	d.				£	s.	d.
Half Year 1	To Hire Vendor .		37	10	0	Half Year 1	By Profit and Loss Account .		25	0	0
							,, Balance . .	c/d	12	10	0
			£37	10	0				£37	10	0
Half Year 2	To Balance . .	b/d	12	10	0	Half Year 2	By Profit and Loss Account .		12	10	0

Dr. **HIRE VENDOR** **Cr.**

			£	s.	d.				£	s.	d.
Half Year 1	To Cash . . .		525	0	0	Half Year 1	By Sundries . .		1,037	10	0
	,, Balance . .	c/d	512	10	0						
			£1,037	10	0				£1,037	10	0
Half Year 2	To Cash . . .		512	10	0	Half Year 2	By Balance . .	b/d	512	10	0

Method 3—

Dr. **MACHINERY** **Cr.**

			£	s.	d.				£	s.	d.
Half Year 1	To Hire Vendor .		500	0	0	Half Year 1	By Balance . .	c/d	500	0	0
Half Year 2	To Balance . .	b/d	500	0	0	Half Year 2	By Balance . .	c/d	1,000	0	0
	,, Hire Vendor .		500	0	0						
			£1,000	0	0				£1,000	0	0
Half Year 3	To Balance . .	b/d	1,000	0	0						

Dr. **INTEREST** **Cr.**

			£	s.	d.				£	s.	d.
Half Year 1	To Vendor . . .		25	0	0	Half Year 1	By Profit and Loss Account . .		25	0	0
Half Year 2	To Vendor . . .		12	10	0	Half Year 2	By Profit and Loss Account . .		12	10	0

Dr. HIRE VENDOR *Cr.*

		£	s.	d.			£	s.	d.
Half Year 1	To Cash	525	0	0	Half Year 1	By Machinery	500	0	0
						,, Interest	25	0	0
		£525	0	0			£525	0	0
Half Year 2	To Cash	512	10	0	Half Year 2	By Machinery	500	0	0
						,, Interest	12	10	0
		£512	10	0			£512	10	0

The above would appear in the Balance Sheet—

		£	s.	d.	£	s.	d.	£	s.	d
	ASSETS									
Method 1—										
Half Year 1.	Machinery				1,000	0	0			
	Less H.P. Creditor				500	0	0			
								500	0	0
Half Year 2.	Machinery							1,000	0	0
Method 2—										
Half Year 1.	Machinery				1,000	0	0			
	Less H P. Creditor	512	10	0						
	Less Interest unaccrued.	12	10	0						
					500	0	0			
								500	0	0
Half Year 2.	Machinery							1,000	0	0
Method 3—										
Half Year 1.	Machinery							500	0	0
Half Year 2.	Machinery							1,000	0	0

Depreciation. The depreciation to be written off must be calculated on the cash value of the asset, that is to say, its full value, but the student must bear in mind that the cash value in method 3 is not arrived at until the end of the period. The entries recording the depreciation are the usual ones, viz.—

Debit Depreciation. Credit Asset.

In method 3, however, it is advisable to keep a Depreciation Account quite separate from the Asset Account. Further, it must be noted that neither the Interest Account nor the Hire Vendor's Account will be affected by the depreciation entries.

Illustration. In the above illustration the rate of depreciation is to be taken at 10 per cent on the decreasing balance each half year.

Methods (1) and (2)—

Dr. MACHINERY **Cr.**

			£				£
Half Year 1	To Hire Vendor		1,000	Half Year 1	By Depreciation		100
					" Balance	c/d	900
			£1,000				£1,000
Half Year 2	To Balance	b/d	900	Half Year 2	By Depreciation		90
					" Balance	c/d	810
			£900				£900
Half Year 3	To Balance	b/d	810				

Method (3)—

Dr. MACHINERY **Cr.**

			£				£
Half Year 1	To Hire Vendor		500	Half Year 1	By Depreciation		100
					" Balance	c/d	400
			£500				£500
Half Year 2	To Balance	b/d	400	Half Year 2	By Depreciation		90
	" Hire Vendor		500		" Balance	c/d	810
			£900				£900
Half Year 3	To Balance	b/d	810				

Alternatively—

Dr. MACHINERY **Cr.**

			£				£
Half Year 1	To Hire Vendor		500	Half Year 1	By Balance	c/d	500
Half Year 2	To Balance	b/d	500	Half Year 2	By Balance	c/d	1,000
	" Hire Vendor		500				
			£1,000				£1,000
Half Year 3	To Balance	b/d	1,000				

Dr. DEPRECIATION **Cr.**

			£				£
Half Year 1	To Balance	c/d	100	Half Year 1	By Profit and Loss Account		100
Half Year 2	To Balance	c/d	190	Half Year 2	By Balance	b/d	100
					" Profit and Loss Account		90
			£190				£190
				Half Year 3	By Balance	b/d	190

The alternative merely shows depreciation as a separate Provision instead of by way of deduction from the asset.

The Balance Sheet would appear as shown in the previous illustration, with the additional deduction of depreciation, e.g.

Method (3)—

Assets		£	£
Half Year 1.	Machinery . . .	500	
	Less Depreciation . .	100	
			400
Half Year 2.	Machinery . . .	900	
	Less Depreciation . .	90	
			810

Illustration. A delivers machinery on the hire purchase system for £2,500 to be paid as follows: on delivery, £400; at the end of the first year, £600; second year, £400; third year, £1,100; interest, included in the £2,500, being charged on the cash value at 10 per cent per annum. Show entries in the books of the hire purchaser, the latter writing off Depreciation at the rate of 5 per cent per annum on the diminishing balance system.

HIRE PURCHASER'S BOOKS—

Dr. MACHINERY *Cr.*

			£	s.	d.				£	s.	d.
Year 1	To Hire Vendor .		2,102	9	7	Year 1	By Depreciation .		105	2	6
							,, Balance . .	c/d	1,997	7	1
			£2,102	9	7				£2,102	9	7
Year 2	To Balance . .	b/d	1,997	7	1	Year 2	By Depreciation .		99	17	4
							,, Balance . .	c/d	1,897	9	9
			£1,997	7	1				£1,997	7	1
Year 3	To Balance . .	b/d	1,897	9	9	Year 3	By Depreciation .		94	17	6
							,, Balance . .	c/d	1,802	12	3
			£1,897	9	9				£1,897	9	9
Year 4	To Balance . .	b/d	1,802	12	3						

Dr. HIRE VENDOR *Cr.*

			£	s.	d.				£	s.	d.
Year 1	To Cash (beginning)		400	0	0	Year 1	By Machinery .		2,102	9	7
	,, Cash (end) .		600	0	0		,, Interest . . (10% on £1,702 9s. 7d.)[1]		170	5	0
	,, Balance . .	c/d	1,272	14	7						
			£2,272	14	7				£2,272	14	7
Year 2	To Cash. . .		400	0	0	Year 2	By Balance . .	b/d	1,272	14	7
	,, Balance . .	c/d	1,000	0	0		,, Interest . . (10% on £1,272 14s. 7d.)[1]		127	5	5
			£1,400	0	0				£1,400	0	0
Year 3	To Cash. . .		1,100	0	0	Year 3	By Balance . .	b/d	1,000	0	0
							,, Interest . . (10% on £1,000)[1]		100	0	0
			£1,100	0	0				£1,100	0	0

[1] The interest calculations are explained on the next page.

The interest is calculated as follows—

		£	s.	d.	£	s.	d.
3rd year .	$\frac{1}{11}$ ×	1,100	0	0 =	100	0	0
2nd year .	$\frac{1}{11}$ ×	1,400	0	0 =	127	5	5
1st year .	$\frac{1}{11}$ ×	1,872	14	7 =	170	5	0

The hire purchaser will show the asset in the Balance Sheet (as if he had actually bought it), less depreciation, less the amount still owing to the hire vendor on hire purchase, e.g. in the second year—

	£	s.	d.	£	s.	d.
Machinery on Hire Purchase—						
Balance . . .	1,997	7	1			
Less Depreciation at 5% p.a.	99	17	4			
	1,897	9	9			
Less Hire Vendor . .	1,000	0	0			
				897	9	9

Method 3. The entries are shown in Journal form, as the examiners usually ask for Journal entries in this particular type of problem. Narratives are ignored.

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			£	s.	d.	£	s.	d.
Year 1 (commencement)	Machinery . . .	*Dr.	400	0	0			
	To Hire Vendor . . .					400	0	0
Year 1 (end)	Machinery	*Dr.	429	15	0			
	Interest	Dr.	170	5	0			
	To Hire Vendor . . .					600	0	0
Year 1 (end)	Profit and Loss Account	Dr.	105	2	6			
	To Machinery—Depreciation					105	2	6
Year 2 (end)	Machinery	*Dr.	272	14	7			
	Interest	Dr.	127	5	5			
	To Hire Vendor . . .					400	0	0
Year 2 (end)	Profit and Loss Account	Dr.	99	17	4			
	To Machinery—Depreciation					99	17	4
Year 3 (end)	Machinery	*Dr.	1,000	0	0			
	Interest	Dr.	100	0	0			
	To Hire Vendor . . .					1,100	0	0
Year 3 (end)	Profit and Loss Account	Dr.	94	17	6			
	To Machinery—Depreciation					94	17	6

Notes—

(1) The Hire Vendor's Account will be debited in the usual way with the cash paid.

(2) If the entries are to be made as "Cash" entries, i.e. without the employment of the personal account of the Hire Vendor, the word Cash will take the place of Hire Vendor.

(3) The depreciation may be written off the account each year, or credited to a Depreciation Account, and at the end of the third year transferred to Machinery Account.

(4)* The total of the debits to Machinery Account is £2,102 9s. 7d., as shown in the account on page 518.

General Illustration. On 1st January, 1953, A acquires on hire purchase from B, machinery valued at £12,000 payable in three yearly instalments of £4,000, plus interest at 6 per cent per annum. Only one instalment was paid, and B arranged immediately the second instalment had become due to take back machinery, which cost £8,000, allowing £4,500 therefor, providing that A paid all the interest due to that date on the full amount owing.

A had written off depreciation at 10 per cent per annum on the diminishing balance. Show the Machinery Account and B's Account in the books of A.

Dr. MACHINERY *Cr.*

			£				£
1953 Jan. 1	To B		12,000	1953 Dec. 31	By Depreciation .		1,200
					,, Balance . .	c/d	10,800
			£12,000				£12,000
1954 Jan. 1	To Balance. . .	b/d	10,800	1954 Dec. 31	By Depreciation[1] .		1,080
					,, B . . .		4,500
					,, Profit and Loss Account—Loss . .		1,980
					,, Balance .	c/d	3,240
			£10,800				£10,800
1955 Jan. 1	To Balance. . .	b/d	3,240				

Dr. B *Cr.*

			£				£
1953 Dec. 31	To Balance. . .	c/d	12,720	1953 Jan. 1	By Machinery . .		12,000
				Dec. 31	,, Interest at 6% per annum on £12,000 for Year . .		720
			£12,720				£12,720
1954 Jan. 1	To Cash . . .		4,720	1954 Jan. 1	By Balance . .	b/d	12,720
Dec. 31	,, Balance. . .	c/d	8,480	Dec. 31	,, Interest at 6% per annum on £8,000 for Year . .		480
			£13,200				£13,200
	To Cash (Interest) .		480		By Balance . .	b/d	8,480
	,, Machinery . .		4,500				
	,, Balance. . .	c/d	3,500				
			£8,480				£8,480
				1955 Jan. 1	By Balance . .	b/d	3,500

[1] Diminishing balance method employed.

The amount to be written off from the Machinery Account may be found as follows—

	Machinery Retained	Machinery Returned	Total
	£	£	£
Cost Price	4,000	8,000	12,000
Less 1st year's Depreciation—10%	400	800	1,200
	3,600	7,200	10,800
Less 2nd year's Depreciation—10%	360	720	1,080
	£3,240	6,480	£9,720
Less Allowance		4,500	
Balance = Loss		£1,980	

The cost of the machinery retained has been paid for together with the interest to date, and so if the machinery were taken back at the original price of £8,000, the account would be clear; but only £4,500 is allowed on its return by the vendor B, and thus his account stands in credit for the sum of £3,500.

As the machinery retained is paid for, and there is still £3,500 due to B, it is necessary to reconcile this with the loss of £1,980 on the returned machinery written off from the Machinery Account. The £3,500 is made up thus—

	£
Depreciation—1st year	800
2nd year	720
Loss on Machinery returned	1,980
	£3,500

Thus, apart from the machinery retained, the Hire Purchaser owes B £3,500, of which £1,520 represents normal depreciation and £1,980 loss. The latter sum is equal to £6,480, less £4,500 allowed by B, as shown above.

EXAMINATION PROBLEM

Renters, Ltd., entered into a hire purchase agreement with Owners, Ltd., for the purchase of 100 wagons over a period of three years from 1st January, 1953, by half-yearly instalments of £738 7s. 10d., payable on 30th June, and 31st December each year, the cash price being £40 per wagon and the rate of interest at 6 per cent per annum with half-yearly rests.

On 1st January, 1954, after paying two instalments, Renters, Ltd., transferred their rights in the agreement to Assignees, Ltd., for a consideration of £1,000. Assignees, Ltd., paid this sum to Renters, Ltd., on 1st January, 1954, and the next instalment to Owners, Ltd., on the due date.

Show in the form of Journal Entries how the transaction should appear in the books of Assignees, Ltd., up to 30th June, 1954, when their financial year ended, writing off depreciation at the rate of 10 per cent per annum.

(*Institute of Chartered Accountants Final.*)

JOURNAL

		£	s.	d.	£	s.	d.
1954 Jan. 1	Wagons . . . . . . *Dr.*	3,744	13	3			
	To Renters, Ltd.				1,000	0	0
	,, Owners, Ltd.				2,744	13	3
	Being the taking over of 100 Wagons on hire purchase as per agreement.						
June 30	Interest . . . . . . *Dr.*	82	6	10			
	To Owners, Ltd.				82	6	10
	Being Interest on £2,744 13s. 3d. at 6 per cent per annum for six months to date, under hire purchase agreemert.						
	Owners, Ltd. . . . . . *Dr.*	738	7	10			
	To Cash				738	7	10
	Being payment of instalment per agreement						
	Depreciation . . . . . *Dr.*	187	4	8			
	To Wagons				187	4	8
	Being Depreciation at 10 per cent per annum on £3,744 13s. 3d. for six months to date.						

The Balance due to Owners, Ltd., on 1st January, 1954, is computed as follows—

	£	s.	d.
Cash Value of Wagons, 1st January, 1953	4,000	0	0
Interest, six months to 30th June, 1953.	120	0	0
	4,120	0	0
Less Instalment paid	738	7	10
	3,381	12	2
Interest, six months to 31st December, 1953 . . .	101	8	11
	3,483	1	1
Less Instalment paid	738	7	10
Balance, 31st December, 1953	£2,744	13	3

General Illustration. On 1st January, 19.., Gatley Garages, Ltd., acquired a new petrol pump on hire purchase from the Victoria Oil Company, which agreed to supply the hire purchasers with petrol at 1s. 6d. a gallon, 3d. of which was to be credited to the suppliers in part payment of the pump and interest at 5 per cent per annum on outstanding balances of purchase price of the pump at the end of each quarter. The cash price of the pump was £100.

Petrol purchased from the Victoria Oil Company in the four quarters ended 31st December, 19.., was 2,000, 2,400, 4,000, and 1,600 gallons.

Depreciation at the rate of 10 per cent per annum is to be written off the Pump.

Show (1) the Journal entries in respect of the quarter ended 30th September, 19..; (2) Ledger Accounts for the four quarters ended 31st December, 19.., in the books of Gatley Garages, Ltd.; and (3) a statement of the apportionments of the invoice charges.

(1) JOURNAL

		£	s.	d.	£	s.	d.
19..							
Sept. 30	Petrol Purchases . . . . . Dr.	250	0	0			
	Petrol Pump . . . . . . Dr.	47	4	1			
	Interest . . . . Dr.		11	11			
	To Victoria Oil Company . . .				297	16	0
	Being purchase of 3,824 gallons of petrol at 1s. 6d. a gallon, 3d. a gallon of which is apportioned to final instalment on pump plus interest on £47 4s. 1d. at 5% per annum for three months to date; together with purchase of 176 gallons of petrol at 1s. 3d. a gallon.[1]						

(2) Ledger Accounts—

Dr. PETROL PURCHASES Cr.

			£	s.	d.				£	s.	d.
19..						19..					
Mar. 31	To Victoria Oil Company . . [2,000 gallons at 1s. 3d.]		125	0	0	Dec. 31	By Trading and Profit and Loss Account . .		625	0	0
June 30	" do. do. . [2,400 gallons at 1s. 3d.]		150	0	0						
Sept. 30	" do. do. . [4,000 gallons at 1s. 3d.]		250	0	0						
Dec. 31	" do. do. . [1,600 gallons at 1s. 3d.]		100	0	0						
			£625	0	0				£625	0	0

Dr. PETROL PUMP Cr.

			£	s.	d.				£	s.	d.
19..						19..					
Mar. 31	To Victoria Oil Co.		23	15	0	Dec. 31	By Trading and Profit and Loss Account—Depreciation on £100 at 10% per annum .		10	0	0
June 30	" do. do. .		29	0	11		" Balance . .	c/d	90	0	0
Sept. 30	" do. do. .		47	4	1						
			£100	0	0				£100	0	0
19..											
Jan. 1	To Balance . .	b/d	90	0	0						

Dr. INTEREST Cr

		£	s.	d.			£	s.	d.
19..					19..				
Mar. 31	To Victoria Oil Company [Interest on £100 at 5% per annum for 3 months.]	1	5	0	Dec. 31	By Trading and Profit and Loss Account	2	16	0
June 30	" do. do. [Interest on £76 5s. at 5% per annum for 3 months.]		19	1					
Sept. 30	" do. do. [Interest on £47 4s. 1d. at 5% per annum for 3 months.]		11	11					
		£2	16	0			£2	16	0

[1] Actually the latter item (176 gallons) would be passed through the Purchases Account in the ordinary way, as no further loading is necessary. If this were done the Journal entries on 30th September, 19.., would be—

JOURNAL

	£	s.	d.	£	s.	d.
Petrol Purchases . . . . . Dr.	239	0	0			
Petrol Pump . . . . . . Dr.	47	4	1			
Interest . . . . Dr.		11	11			
To Victoria Oil Company . . .				286	16	0

(3) The invoices will be apportioned thus—

Quarter	Invoice	Total £	s.	d.	Petrol Purchases £	s.	d.	Pump Purchase £	s.	d.	Interest £	s.	d.
19..													
March 31.	2,000 gallons at 1s. 6d. . .	150	0	0	125	0	0	23	15	0	(a) 1	5	0
June 30.	2,400 gallons at 1s. 6d. . .	180	0	0	150	0	0	29	0	11	(b)	19	1
Sept. 30.	3,824 gallons at 1s. 6d. .	286	16	0	239	0	0	47	4	1	(c)[1]	11	11
	176 gallons at 1s. 3d. . .	11	0	0	11	0	0						
Dec. 31.	1,600 gallons at 1s. 3d. . .	100	0	0	100	0	0						
		£727	16	0	£625	0	0	£100	0	0	£2	16	0

(*a*) Interest on £100 at 5 per cent per annum for three months.
(*b*) Interest on £76 5s. at 5 per cent per annum for three months [£100 less £23 15s.].
(*c*) Interest on £47 4s. 1d. at 5 per cent per annum for three months [£76 5s. less £29 0s. 11d.].

The information required is presented in the same order as stated in the question, but the apportionment table should first be constructed from which to write up the accounts.

SALE FOR DEFERRED PAYMENT BY INSTALMENTS

Hire Purchase and Purchase by instalments, although outwardly similar transactions as they both involve periodical payments to the vendor, are fundamentally different, the former being a transaction of hire with ultimate sale, the latter of immediate sale in which the price, instead of being paid in one sum, is spread over a period, interest being charged. In a deferred payment sale the vendor has no legal right to reclaim the goods upon default, his only remedy being to sue for the unpaid balance. It is therefore of great importance to make adequate provision against bad debts.

Summary of Difference between Hire Purchase and Purchase by Instalments

	H.P.	P.I.
Nature of Contract	Agreement of Hiring.	Agreement of Sale.
Governing Act .	Hire Purchase Act, 1938.[2]	None.
Passing of Title .	As agreed, usually on last payment or final nominal consideration.	When parties agree as with usual sale.
Rights of Deliveree	As laid down in Hire Purchase Act, 1938; briefly, may return goods without further payment, except for accrued instalments.	Unless seller defaults, goods not returnable and deliveree liable for price agreed, or reasonable price if not agreed.
Rights of Seller .	May recover goods if hirer is in default.	Can sue for price if buyer in default.
Rights of Disposal	Hirer cannot hire out, sell, pledge nor assign entitling transferee to retain as against Hire Seller.	May dispose, and give good title to *bona fide* purchaser.

[1] The interest is actually 11s. 10d., but as this would involve calculating a fraction of a gallon, the charge of 11s. 11d. would be made and an allowance made for the penny "overcharge."

[2] See footnote on next page.

Entries in the Vendor's Books

Subject to the different legal position, the entries are similar to those for ordinary sales; the cash value of the goods is credited to Sales Account and debited to the Personal Account of the purchaser. Interest at the agreed amount is credited to Interest Account and debited to the account of the purchaser as each instalment is paid; alternatively, as in the case of hire purchase transactions, a composite sum representing interest plus cash value may be debited to the account of the purchaser, who agrees to pay in equal instalments. In the Balance Sheet the balance of the Purchaser's Account is shown as a debtor for the amount owing. The entries are thus similar to those effected where hire purchase transactions are recorded as sales and interest charged; the entries in the books of the purchaser are also similar.

Also restricted by the Hire Purchase and Credit Sale Agreements (Control) Order 1952 as amended, requiring for certain classes of goods a minimum deposit and a maximum instalment period.

CHAPTER XXI

INCOME TAX IN RELATION TO ACCOUNTS

TAXATION is a branch of accounting work which is of such importance and scope that it is not possible in a work of accountancy to deal with it on adequate lines. It is, however, of importance to the student to understand the book-keeping entries relating to Income Tax and Profits Tax—many examination candidates have great difficulty in dealing with the purely accounting entries, even where the computed liability is given in the question. For intricate and detailed tax problems reference should be made to one of the many excellent works on taxation, but in order to assist in the understanding of the subject, a very broad and general outline of the main principles is given below.

Income Tax. Income Tax is an annual tax levied on the statutory income for the tax year (6th April to 5th April following). Statutory income is very rarely the actual income for the year, but is the income computed under the various Income Tax rules. The tax is levied (*a*) by *assessment* on income and profits according to classification under the Schedules listed below, and (*b*) by *deduction* from certain payments, e.g. loan interest, annuities, chief rents, etc., the person making the deduction having to account for the tax to the Inland Revenue.

The Schedules.

Schedule	Tax on	Levied on the
A	Ownership of property	Occupier (in most cases)
B	Occupation of land and farm buildings	Occupier
C	Certain income arising from public funds	Paying agent
D	Annual profits or gains of	Person making the profits or receiving the income, if resident in U.K. wherever the income arises; if non-resident, on income arising in U.K.
Case 1	(*a*) Trade or business in U.K.	
2	(*b*) Profession or vocation in U.K.	
3	Untaxed dividends and interest	
4, 5	Certain foreign income	
6	Income not classified elsewhere	
E	Income from employments, pensions, and offices	Recipient (through the system of P.A.Y.E.)

Basis of Assessment. The assessment is on the *current year's* income or profit computed in accordance with the tax rules, except for Schedule D, Cases 1–5, where for general convenience the assessment is based upon the *preceding year*, with various exceptions for the "early" years of the source of income, e.g. when the business is

set up, and the "late" years, i.e. the year of cessation and the year prior thereto (penultimate year).

Collection of Tax. The tax year is from 6th April to the 5th April following and tax is due under Sch. A on the 1st January in the tax year, under Sch. B in two instalments on the 1st January in the tax year and on the 1st July following. Tax under Sch. C is collected through the medium of the paying agent, usually the Bank of England. Tax under Sch. D is due, in the case of a trade, etc., in two instalments, on the 1st January in the tax year and on the 1st July following: in other cases on the 1st January. Tax under Sch. E is collected from employees by employers under the system of P.A.Y.E. In all cases, however, tax is due from a limited company in one amount on the 1st January in the tax year.

Thus Sch. D (Case I) tax for the year 1953–54 is payable by an individual (or partnership) in two instalments, one on the 1st January, 1954, and the other on the 1st July, 1954, but in the case of a limited company the whole tax would be payable on the 1st January, 1954.

Payment of Tax. When tax is paid, the book-keeping entries are—

Debit Income Tax	Credit Bank

If it is preferred to enter the tax liability immediately on its ascertainment, the entries are—

Debit Income Tax	Credit Commissioners of Inland Revenue

and, on subsequent payment—

Debit Commissioners of Inland Revenue	Credit Bank

In the problems of ordinary accounting (excluding those questions comprising purely income tax matters), a knowledge of income tax is required in dealing with (1) annuities, loan interest, mortgage interest, patent royalties, etc; (2) rents; (3) dividends and interest received; (4) income tax in the accounts of limited companies; and (5) partnerships.

(1) **Annuities, etc.** The Inland Revenue authorities, in order to facilitate the collection of tax, cause the payer of annuities and the like to deduct tax and account for it direct. This is simply part of the machinery of tax collection, the payer having to pay an increased assessment caused by the adding back to the profits of the particular payment, so that the true burden of the payer is unaffected.

Illustration. X has a gross profit of £2,000 from which he deducts general expenses £250, and loan interest of £100 which he has paid less tax of £45. Show how these items would be dealt with in the books of X, ignoring personal allowances.

The book-keeping entries are—

(1) Debit Loan Interest Account with the gross figure of Loan Interest (Credit Lender).

(2) Debit Lender with income tax (Credit Income Tax Account).

(3) Debit Lender with cash (Credit Cash Account).

The Accounts would be thus—

Dr. LOAN INTEREST *Cr.*

		£			£
	To Lender	100		By Profit and Loss Account	100

Dr. LENDER *Cr.*

		£			£
	To Income Tax	45		By Loan Interest	100
	,, Cash	55			
		£100			£100

Dr. INCOME TAX *Cr.*

		£			£
	To Commissioners of Inland Revenue	787½		By Lender	45
				,, Capital Account	742½
		£787½			£787½

Dr. PROFIT AND LOSS ACCOUNT *Cr.*

		£			£
	To General Expenses	250		By Gross Profit	2,000
	,, Loan Interest	100			
	,, Profit	1,650			
		£2,000			£2,000

The adjusted profits for Income Tax purposes will be £1,650 + £100 = £1,750, making a tax liability at 9s. in the £ of £787 10s. But, when paying the Loan Interest X deducted tax of £45, making the true burden of tax £787 10s. − £45 = £742 10s. (as shown by the Income Tax Account), which is 9s. in the £ on his net profit of £1,650.

If at the end of the accounting period the interest remained unpaid, entry (3) would be postponed until the subsequent period when payment was made.

The personal account of the Lender may be dispensed with, the entries being made direct to Interest Account as follows—

	Debit Loan Interest (Gross)	Credit Income Tax
		Credit Cash
or	Debit Loan Interest (Net Payment)	Credit Cash
	Debit Loan Interest (Income Tax)	Credit Income Tax

If this is done, the following will take the place of the first three accounts in the above illustration—

Dr. LOAN INTEREST *Cr.*

		£			£
	To Cash	55		By Profit and Loss Account	100
	,, Income Tax	45			
		£100			£100

Dr.		INCOME TAX (includes)			Cr.
					£
			By Loan Interest		45

If at the end of the accounting period the interest was unpaid, the item of £55 shown as Cash paid in the Loan Interest Account would not appear, and £55 would be brought down as an accrual (by debiting the account "above the line" and crediting "below the line") and shown as a liability in the Balance Sheet.

It happens frequently in examination papers that provision has to be made for a half year's liability for interest. This often causes confusion in the mind of the candidate. If the personal account is being used, the double entry will be—

Debit Loan Interest (Gross: ½ year)	Credit Income Tax (for Tax) Credit Personal Account (for net liability, which will be shown in the Balance Sheet).

If there is no personal account, the accrual should be brought down in the Interest Account, as described in the preceding paragraph.

The important points to remember are—

(1) The *liability* must be shown either in the personal account or as an accrual in the loan Interest Account, and

(2) There will be a credit to Income Tax Account in respect of the income tax deductible (apart from exceptional circumstances), because the assessment (causing the debit to Income Tax Account) is based upon the adjusted profits after adding back the loan interest, the tax deductible from such interest being in effect a reduction of the inflated liability.

At the end of the year the Loan Interest Account will be closed off to Profit and Loss Account and will represent the *gross*, not net Interest.

Illustration. In the accounts of L appears £110 net Loan Interest for the half year to 30th June, 1953, paid on that date. L's accounting period ends on 31st December, 1953, and provision is to be made for the half year's accrual of Loan Interest. Show Ledger Accounts, assuming no personal accounts opened and taking tax at 9s. in the £.

Dr.		LOAN INTEREST					Cr.
1953			£	1953			£
June 30	To Cash		110	Dec. 31	By Profit and Loss A/c		400
	„ Income Tax		90				
Dec. 31	„ Interest Accrued	c/d	110				
	„ Income Tax		90				
			£400				£400
				1954			
				Jan. 1	By Balance	b/d	110

Dr. INCOME TAX (includes) *Cr.*

				1953			£
				June 30	By Loan Interest . .		90
				Dec. 31	„ Loan Interest . .		90

(2) **Rents.** Where property is let to a tenant, the Inland Revenue authorities assess the Schedule A Tax upon the occupier (subject to certain exceptions). If the occupier has recently bought the property, such a fact does not concern the authorities, as the former must ensure for himself that the tax in respect of a period prior to his ownership is credited or paid to him by the vendor.

The payment of tax by the tenant is in reality a part payment of RENT since he recoups himself from the next rent(s), and although it is paid in the form of income tax it is (subject to an exception mentioned on page 531) as much in reality rent as if the landlord paid his own Schedule A tax and the tenant paid his rent in full in the usual way.

The book-keeping entries are—

(1) Debit Rent. Credit Landlord (with full rent).
(2) Debit Landlord. Credit Cash (when Sch. A tax is paid) *or* Credit Inland Revenue (with tax provision).
(3) Debit Landlord. Credit Cash (on payment of amount due to Landlord resulting from (1) and (2)).

Or, if personal accounts are dispensed with—

(4) Debit Rent (with tax paid). Credit Cash.
(If merely accrued, bring down balance on Rent Account as a liability due to Inland Revenue).
(5) Debit Rent (with payments to Landlord). Credit Cash after deducting (4).
(If merely accrued, bring down balance on Rent Account as a liability due to Landlord).

Illustration. X occupies premises, the net annual value[1] of which is £200. Rents are £240 per annum paid on the usual quarter days. The Demand Note for tax (£200 at, say, 9s.) is paid by the tenant and recouped from the next rents. Show Rent Account in the books of the tenant, assuming no personal accounts kept.

Dr. RENT *Cr.*

19..			£	19 .			£
Jan. 1	To Income Tax, Sch. A .	(a)	90	Dec. 25	By Profit and Loss Account[2] . .		240
Mar. 25	„ Rent for quarter, less Income tax . .		*nil*				
June 24	„ Rent for quarter *less* balance of Income Tax . . .	(a)	30				
Sept. 29	„ „ „ .		60				
Dec. 25	„ „ „ .		60				
			£240				£240

[1] Net annual value is based on gross annual value, less the Statutory Repairs allowance. Net Annual Value (N.A.V.) is the income from property on which tax is assessed under Schedule A.

[2] There would be the usual provision for the accrued and accruing rent if the accounting period ended on any other date than the quarter day.

(a) It will be noted that in effect the tenant pays his March and June rents in two parts: (1) to the Inland Revenue; (2) to the landlord, less his payment to the Inland Revenue.

Having paid £90 tax, £60 is used to discharge the March quarter's rent, leaving £30 to be deducted from the June quarter's rent.

An extremely important qualification to the tenant's right of recoupment of the *whole* income tax paid arises when the tenant occupies premises at a comparatively low rent, because the recoupment is restricted to income tax on the rent paid if *lower* than the net annual value. Put another way: the tenant is permitted to deduct tax from his next payments of rent on the lower of two figures, viz. net annual value or rent.

Reverting to the preceding illustration, the tenant's rent is higher than the net annual value, so that he is able to deduct tax only on the latter figure, which leaves him with no burden other than rent, as the tax paid is fully deducted from the next payments to the landlord, but supposing the rents were £160 per annum, the position is as follows: the tax is paid on the net annual value, viz. £200 at 9s., £90, but the tenant may recoup himself only to the extent of £160 (rent being the lower figure) at 9s., £72, thus leaving him with a tax burden of £18, which represents tax at 9s. on the benefit of £40. As the net annual value represents (in theory at all events) the fair letting value of the property, and the tenant obtains the enjoyment of premises at a rental less than the fair value, it is but just that he should suffer the tax on the differential advantage so obtained: whilst it would be manifestly unjust to throw the incidence of it upon the landlord. The latter will bear tax on the rents only where less than the net annual value.

The £18 above mentioned is TAX, not rent, and so must be added back to the profits for the purpose of computing income tax liability, but the tenant will eliminate from his profits the amount of £40 as he has paid tax on this sum. In other words, by having suffered tax of £18 he has virtually put himself into the position of being able to maintain that his rent is the equivalent of £200 and not £160.

Illustration. Using the above facts, show the Rent Account of the tenant.

Dr. RENT *Cr*

19..			£	19 .			£
Jan. 1	To Income Tax, Sch A .		90	Dec. 25	By Income Tax Account—Tax on £40 at 9s .		18
Mar. 25	,, Rent for quarter £40 less Income Tax on £160 at 9s. £72 .		—		,, Profit and Loss Account . .		160
June 24	,, Rent for quarter £40 *less* balance of Income Tax . .		8				
Sept. 29	,, ,, ,, .		40				
Dec. 25	,, ,, ,, .		40				
			£178				£178

The tenant pays £90 (£200 at 9s.) but recoups £72 (£160 at 9s.).

Alternatively, the items for tax may be debited to Income Tax Account (i.e. £90) and the recoupable portion thereof (i.e. £72)

transferred therefrom to the debit of Rent Account, leaving the unrecoupable balance (i.e. £18) in the debit of Income Tax Account thus—

Dr.		RENT			*Cr.*
19..		£	19..		£
Jan. 1	To Income Tax Account: Tax recoupable £160 at 9s. . . .	72	Dec. 25	By Profit and Loss Account . .	160
Mar. 25	„ Rent for quarter £40 *Less* Income Tax 40	*nil*			
June 24	„ Rent for quarter £40 *Less* Balance of Income Tax . 32	8			
Sept. 29	„ „ „ .	40			
Dec. 25	„ „ „ .	40			
		£160			£160

Dr.		INCOME TAX (includes)			*Cr.*
19..		£	19..		£
Jan. 1	To Income Tax Sch. A £200 at 9s. . .	90	Jan. 1	By Rent Account: Income Tax Sch. A recoupable £160 at 9s. .	72

(3*a*) **Dividends and Interest Received net,** i.e. after deduction of tax at source. Where loan interest is paid it has been seen that the payer must account to the Inland Revenue for the tax deducted by him from the payment. This is so even if the borrower is not liable for income tax. On the other hand, dividend and loan interest will be received "net," that is, after the deduction of the income tax by the payer, so that such income must be deleted from the profits of a business for income tax purposes, as the tax has already been suffered. The amount to be deleted is that actually appearing in the accounts analogous to the adding back of loan interest paid (as was seen on page 528). If the income has been "grossed up" there will be a corresponding debit for income tax on the Profit and Loss Account which will have to be added back, so that the gross dividend will be deleted and the income tax on it added back, giving the same result as if the amount had been entered in the accounts at the net figure. In the case of an individual, owing to personal allowances, the recipient of the net dividend and interest may obtain total repayment or relief according to circumstances; but this does not affect the treatment of the dividend and interest in the accounts for the purposes of income tax computation on the business profits.

The book-keeping entries are—

Debit Cash (with net amount received) Debit Income Tax (with tax deducted)	Credit Dividends Received (gross)

Alternatively—

Debit Cash (with net amount received)	Credit Dividends Received (net)
Debit Income Tax (with tax deducted)	Credit Dividends Received (net)

The entries for Interest received after deduction of tax will be similar to the above. Where personal accounts are used, the entries will be reverse to those given on page 527.

It should be noted that (as with payments made after deduction of tax) the correct figure to bring into the accounts is the *gross* amount of the dividend or interest and not the net amount actually received.

Illustration. A has a gross profit of £2,000 from which is deducted £250 general expenses, and to which is added £55 "net" dividend after the deduction of income tax at 9s. in the £. Show how these items would be dealt with in A's books, ignoring personal allowances.

Dr. INCOME TAX *Cr.*

		£	s.	d.			£	s.	d.
	To Commissioners of Inland Revenue	787	10	0		By Capital Account	832	10	0
	" Tax deducted from Dividends	45	0	0					
		£832	10	0			£832	10	0

Dr. DIVIDENDS RECEIVED *Cr.*

		£	s.	d.			£	s.	d.
	To Profit and Loss Account	100	0	0		By Cash	55	0	0
						" Income Tax	45	0	0
		£100	0	0			£100	0	0

Dr. COMMISSIONERS OF INLAND REVENUE *Cr.*

		£	s.	d.			£	s.	d.
						By Income Tax	787	10	0

Dr. PROFIT AND LOSS ACCOUNT *Cr.*

		£			£
	To General Expenses	250		By Gross Profit	2,000
	" Net Profit	1,850		" Dividends	100
		£2,100			£2,100

The adjusted profits for Income Tax purposes will be £1,850 less £100 = £1,750, making a tax liability at 9s. in the £ of £787 10s. A has, however, already suffered tax of £45 deducted from his dividends, so that his true tax burden is £832 10s. (as shown by the Income Tax Account) which is equal to 9s. in the £ on his net profit of £1,850.

(3*b*) **Dividends and Interest Received Gross** (Case III, Schedule D). Dividends are receivable gross in the following cases—

(1) On certain Government securities, e.g. 3½ per cent War Loan.

(2) On all Government securities on the Post Office Register.

(3) On Government securities on the Bank of England Register, provided that the annual interest does not exceed £5.

(4) Companies under the Industrial and Provident Societies Acts.

(5) Bank interest.

The matter is simply adjusted by deletion from the adjusted profits of the business and tax paid on the basis of the income up to the 5th April preceding the year of assessment, although in the case of bank interest received the year to the 31st December preceding is taken as the assessable period; so that, where the accounting period is not coincident with the tax year, the figure deleted from the accounts may not correspond with the amount assessed, as in the first case the deletion may be in respect of interest for the year to (say) 31st October, whilst the assessment will be based upon the income to the 5th April, but over a period the same total assessment will generally result.

The book-keeping entries are—

Debit Cash Credit Dividends or Interest Received (with amount received)

Since there will be an assessment under Sch. D, Case III in respect of the income, the necessary provision should be made by debiting Income Tax Account and crediting Commissioners of Inland Revenue, or by debiting Income Tax Account "above the line" and crediting "below the line." When the tax is paid, Income Tax (or Commissioners) will be debited and Cash credited.

It may here be noted that a "tax free" or "free of tax" dividend is not the same as a dividend received gross. It is merely an alternative expression for a net dividend. Thus, a dividend of £110 "free of tax" is the same, taking tax at 9s. in the £, as a gross dividend of £200 less tax £90. Such dividends must, therefore, be grossed up and treated in the manner described in section (3a).

Illustration Write up the undermentioned transactions of A—

1950

Jan. 1. Payment of Schedule A Tax on £52 for 1953–54 (in respect of premises occupied by him as tenant).

3. Payment of 1st instalment of Case I Schedule D tax, liability for 1953–54 is £480.

5. Received Interest on 2½ per cent Consols (Post Office Register) of £2.

Mar. 1. Paid Loan Interest of £100 less tax.

10. Received year's Dividend of £40 less tax.

25. Paid half year's rent to date £24.

Apr. 5. Received Interest on 2½ per cent Consols of £2.

Provide for Tax as on 5th April, assuming liability of taxpayer at say 9s. in £.

Work to the nearest £.

Cash Book

Dr.							Cr.
1954			£	1954			£
Jan. 5	To Interest and Dividend Account: one quarter's interest on 2½ per cent Consols (Gross) . . .		2	Jan. 1	By Rent Account: Sch. A Tax 1953–54		24
Mar. 10	,, Interest and Dividend Account. dividend on shares . . £40 *Less* tax . 18		22	5	,, Commissioners of Inland Revenue Case I Sch.D. Tax 1953–54 1st instalment ½ × £480 . . .		240
Apr. 5	,, Interest and Dividend Account: one quarter's interest on 2½ per cent Consols (Gross) . . .		2	Mar. 1	,, Loan Interest . £100 *Less* tax 45		55
				25	,, Rent for half-year to date . £24 *Less* tax at 9s. on £48 . 22		2

Rent

Dr.							Cr.
1954			£	1954			£
Jan. 1	To Income Tax £52 at 9s.		24	Mar. 25	By Income Tax Account: tax unrecoupable £4 at 9s.[1] . . .		2
Mar. 25	,, Half-year's rent £24 *Less* tax 22		2	Apr. 5	,, Profit and Loss Account . .		24
			£26				£26

Interest and Dividend

Dr.							Cr.
1954			£	1954			£
Mar. 1	To Cash: Loan Interest to date . £100 *Less* tax . 45		55	Jan. 5	By Cash· 2½ per cent Consols quarter's Interest		2
	,, Income Tax Account		45	Mar. 10	,, Cash: Dividend on shares . . £40 *Less* tax . 18		22
					,, Income Tax Account.		18
				Apr. 5	,, Cash. 2½ per cent Consols quarter's interest		2
					,, Profit and Loss Account .		56
			£100				£100

Income Tax

Dr.							Cr.
1954			£	1954			£
Jan. 3	To Cash—Case I, Sch. D. 1953 54 1st instalment . . .		240	Mar. 1	By Loan Interest . .		45
Mar. 10	,, Dividend on shares .		18		,, Drawings Account .		457
25	,, Rent Account . .		2				
Apr. 5	,, Balance 2nd Instalment of Case I Sch. D 1953–54 .	c/d	240				
	,, [2]Balance. Case III Sch. D 1953–54 .	c/d	2				
			£502				£502
				Apr. 6	By Balance: Case I Sch. D.	b/d	240
					,, Balance: Case III Sch D. . . .	b/d	2

[1] A is entitled to deduct tax on £48 (not £52), leaving A with a liability of £4 at 9s. = £1 16s. (£2 to the nearest £); the above transfer leaves his Rent Account with £24 for the half-year, which is the due rent.

[2] Assumed that the income on the 2½ per cent Consols was first received on 5th January, 1954, tax thereon being £4 at 9s. in the £ = £1 16s. (£2 to the nearest £).

(4) **Limited Company Income Tax.** The assessment will be based upon the profits of the company adjusted for income tax purposes, and provision for the charge will be brought into the books by debiting Profit and Loss (or Appropriation) Account and crediting Income Tax Account, the latter account being debited and Cash being credited on payment. The Income Tax Account will also be debited or credited, as the case may be, in respect of dividends and interest received net and annual charges paid after deduction of tax, so that these items are shown gross in the accounts as already described in this chapter. After adequate provision has been made (as will be described later), the Income Tax Account will be closed off to the Profit and Loss Account or Appropriation Account, since in law income tax is an *appropriation* of profits.

When dividends are paid by the company, income tax must be deducted therefrom at the standard rate, but the amounts so paid out do not in any way (considerations of Profits Tax being ignored) affect the tax payable by the company. Logically it might seem that the procedure in reverse to that outlined for dividends received should be followed for dividends paid, except that the ultimate transfer of the latter would be to Profit and Loss Appropriation Account. It is the established practice, however, to bring dividends payable into the accounts only to the extent of the *net* amount, ignoring the tax thereon, so that the book-keeping entries will be—

Debit Dividend Payable (net)	Credit Cash or Provision for Dividend Payable

An illustration of taxation in the books of a limited company will be found on page 543. Dividends are dealt with in greater detail in Chapter XXIII.

(5) **Partnership Accounts.** Owing to the existence of private income, abatements and personal allowances, there will usually be no uniformity of incidence of liability of partners to tax, so that the firm's liability must be apportioned between the partners (from which will be deducted the appropriate personal allowances), and the final amount due from each partner charged to his Current or Drawings Account. Hence, although partners may be "equal" the incidence of tax will normally be unequal.

The allocation of liability between partners is dealt with in the following manner—

(1) The firm's profits are adjusted in the usual way (adding back **partners' salaries and interest on capitals,** and eliminating **interest on drawings,** taxed dividends and income assessable elsewhere (e.g. Case III, Schedule D). From the adjusted profits will be deducted the capital allowances for Plant and Machinery (if any).

(2) Having arrived at the final figure, it is necessary to apportion it as between the partners in the ratio in which profits are shared in the **Current Fiscal** Year, it being quite immaterial what the constitution of the partnership was when the profits (as adjusted)

brought into the assessment were earned. The assessment is the liability not for the last year, but the current year.[1] The PRESENT partners must bear the PRESENT burden, however it is computed.

(3) The earned income and other allowances are deducted from each partner's share of assessment as determined in (2).

Thus, the two important rules are—

(1) Ascertain the adjusted profits of the firm, ignoring the question of the *personnel* of the firm.

(2) Apportion adjusted profits as above ascertained in the manner in which profits and losses are shared in the *current* fiscal year.

It may be noted that a change in the constitution of the partnership will be treated for taxation purposes as a discontinuance of the old, and a commencement of a new business except where there is a continuing partner and all the old and new partners (or their legal representatives) apply within twelve months of the change for assessment in the ordinary way as a continuing business.[2] The former will entail an adjustment of the old firm's profits down to the change as a closed business, involving a readjustment of the penultimate year's assessment should the profits for that year be higher than the assessment already made. The alternative methods, however, do not affect the rule as to the *apportionment* of the liability.

Where assessment as a continuing business is applied for, i.e. on the profits of the preceding period, the adjusted profits will be split if the change has occurred at any date other than the 6th April of the year of assessment, the two parts being respectively the old and the new firm liability. For instance, if a change took place on the 5th October, 1953, the proportion of the adjusted profits brought into liability for the year 1953–54 (based on the preceding period's accounts) will be one-half, that is, from 6th April, 1953, to 5th October, 1953, to the old firm and the remaining half, that is, from 6th October, 1953, to the 5th April, 1954, to the new firm, each part being allocated in the manner of sharing profits (including interest on capital and partnership salaries) in the respective periods.

The above rule applies to all income of the firm, including taxed income. Although the latter will be excluded from the computation for assessment, the gross amount of the shares of dividends and interest must be included in the income tax returns of the partners for the purposes of ascertaining their statutory incomes.

PROVISION FOR PARTNERS' INCOME TAX

At the end of the accounting period, provision should be made for the estimated liability for tax by debiting each Partner's Current Account with his share of liability and crediting Income Tax

[1] Although in normal circumstances (early and closing years are exceptions) based on the profits of the preceding year.

[2] Prior to 1953–54, the reverse applied (S. 19, Finance Act, 1953). Continuing partners may carry forward unrelieved shares of losses in "discontinued" business.

Account, the latter being debited and cash credited upon payment. Any difference between the amount provided for and actually paid in respect of each partner should be transferred back to each Partner's Current Account.

In many cases no provision is made at all for the partners' income tax, so that the appropriate entries will be made only upon payment by debiting each Partner's Current or Drawings Account and crediting cash. In any case, no provision is required as regards income which has already suffered tax.

Illustration. X and Y commenced business on 1st January, 1953, having equal capitals of £4,000 and sharing profits equally.

X is married with two children under 16, Y being single. Partners have no other income. Ignore X's Family Allowance and National Insurance.

They wish to provide for income tax. The charges indicated are paid quarterly on 31st March, 30th June, 30th September, and 31st December.

Show Partners' Current Accounts, Income Tax Account (with computation for 1952–53 and 1953–54) and Loan Interest Account for the year ended 31st December, 1953.

The Profit and Loss Account is as follows—

Dr. PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 1953 *Cr.*

	£			£
To General Expenses (allowable)	3,220	By Gross Profit	b/d	7,470
,, Rent and Rates	650			
,, Patent Royalties	200			
,, Interest on Loan	300			
,, Interest on Capital	400			
,, Net Profit	2,700			
	£7,470			£7,470

Dr. PROFIT AND LOSS ADJUSTMENT ACCOUNT FOR INCOME TAX *Cr.*

	£		£
To Balance, being adjusted profits	3,600	By Net Profit as per Accounts	2,700
		,, Interest on Capital	400
		,, Interest on Loan	300
		,, Patent Royalties	200
	£3,600		£3,600

Firm assessments are—

			£
1952–53	Actual profits (as adjusted) $\frac{3}{12}$ × £3,600	=	900
[1] 1953–54	First year's profits (as adjusted)	=	3,600

[1] If the actual profits for 1953–54 were *less* than the assessment, upon proper application being made to the Inland Revenue, the assessment would be reduced to the actual profits of that fiscal year.

Allocation of liability is as follows—

		1952–53 X	1952–53 Y	1953–54 X	1953–54 Y
		£	£	£	£
Assessment[1]		450	450	1,800	1,800
Less annual charges—					
Royalties	200				
Loan interest	300 [2]	63	62	250	250
		387	388	1,550	1,550

	1952–53 X		1952–53 Y		1953–54 X		1953–54 Y	
Less—								
Earned income allowance[3]	86		86		344		344	
Personal allowance[4]	210		120		210		120	
Child allowance[5]	170	466	—	206	170	724	—	464
Taxable incomes		*nil*		£182		£826		£1 086

	1952–53 X		1952–53 Y		1953–54 X		1953–54 Y	
		£ s d		£ s d		£ s d		£ s d
Tax payable—								
At reduced rate[6]	(—)	– – –	(182)	22 11 0	(400)	102 10 0	(400)	102 10 0
At 9s		– – –		–	(426)	191 14 0	(686)	308 14 0
		– –		£22 11 0		£294 4 0		£411 4 0

In addition the firm must account for tax on charges

£125 at 9s 6d £59 7s 6d — £500 at 9s £225

Total tax payable, 1952–53	£ s d	Total tax payable, 1953–54	£ s d
X	– – –	X	294 4 0
Y	22 11 0	Y	411 4 0
Charges	59 7 6	Charges	225 0 0
	£81 18 6		£930 8 0

Dr INCOME TAX *Cr*

		£	s	d			£	s	d
To Provision	c/d				By Royalties (£50 at 9s 6d £150 at 9s)		91	5	0
1952–53 Assessment		81	18	6	Loan Interest (£75 at 9s 6d £225 at 9s)		136	17	6
1953–54 (proportion to 31st Dec i e ¾ × £930 8s)		697	16	0	Current Accounts—				
					X		[7]220	13	0
					Y		[7]330	19	0
		£779	14	6			£779	14	6
					By Provision	b/d	779	14	6

[1] As Interest on Capitals are equal there is no need to show separately

[2] £500 per annum, £125 for three months only, i e 1st January, 1953, to 31st March, 1953 is the appropriate charge for 1952–53

[3] The allowance is two ninths of the *earned* income less charges (max £450)

[4] Personal allowance is £210 for married man, £120 for single man or woman

[5] Children's allowance (subject to certain conditions) is £85 for each child

[6] Rates of tax on first £100 of taxable income, next £150 next £150 and balance are 1952–53—3s 5s 6d, 7s 6d, and 9s 6d, 1953–54—2s 6d, 5s 7s, and 9s

[7] The transfer to Current Accounts is in respect of tax for the year ended 31st December, 1953, i e 1952–53 (3 months) and 1953–54 (9 months), thus—

£ s d		£ s d			£ s d
220 13 0	=	– – –	+	¾ ×	294 4 0
330 19 0	=	22 11 0	+	¾ ×	411 4 0

Dr. **Partners' Current Accounts** Cr.

		X. £	X. s.	X. d.	Y. £	Y. s.	Y. d.			X. £	X. s.	X. d.	Y. £	Y. s.	Y. d.
To Income Tax Account—								By Interest on Capital		200	0	0	200	0	0
1952–53 Tax		—	—	—	22	11	0	" Profit and Loss Appropriation Account		1,350	0	0	1,350	0	0
1953–54 Tax proportion to 31st Dec. 1953 (i.e. ¾) (a)	1	220	13	0	308	8	0								
" Balances	c/d	1,329	7	0	1,219	1	0								
		£1,550	0	0	£1,550	0	0			£1,550	0	0	£1,550	0	0
								By Balances	b/d	1,329	7	0	1,219	1	0

[1] Income Tax on Earned Income of an individual is payable in two *equal* instalments—1st January and 1st July, 1954, in respect of 1953–54.

(a) ¾ × £294 4s.; and ¾ × £411 4s., the respective assessments for X and Y for 1953–54 as shown on page 539.

Dr.	LOAN INTEREST						*Cr.*
	£	s.	d.		£	s.	d.
To Cash	163	2	6	By Profit and Loss Account	300	0	0
,, Income Tax	136	17	6				
	£300	0	0		£300	0	0

PROVISION FOR TAX IN LIMITED COMPANY ACCOUNTS

The whole of the Income Tax liability of a Limited Company is due for payment on 1st January of each fiscal year, e.g. the liability for 1952–53 is payable on 1st January, 1953.

A Limited Company making up its accounts must make due provision for tax liability. This matter is extremely simple as like most other adjustments it is merely a question of what is accrued, accruing, or prepaid. If a company makes its accounts up to 30th November, there will be accruing eight months of the current fiscal year tax (which will be based upon the preceding year's accounts in the normal course) ; hence, if the assessment for the year is £600, the provision required is $\frac{8}{12} \times £600 = £400$. If the date were 31st December, there would be required nine months' provision, and so on; but as the whole of the tax for the year ended 5th April is payable on 1st January, it is possible that where the company's accounting period ends between 1st January and 5th April, there may have been a prepayment, e.g. if the company's liability for 1952–53 is £1,000, which is paid on 1st January, 1953, the accounting period ending 28th February, 1953, there is a prepayment of ONE month, as the liability has been discharged to 5th April, 1953.

In this way the minimum "legal" provision for taxation is made, but such treatment takes no account of the balance of tax for the current fiscal year, nor of the assessment in the next fiscal year which in normal circumstances, will be based on the current year's profits (i.e. on preceding year basis). The profits of the next period may, therefore, have to bear a charge for taxation quite out of proportion to their size. For this reason it is now the recognized practice to base the charge for income tax in the accounts on the profits shown in those accounts. Thus, not only is the minimum "legal" liability covered but also the liability legally due in the succeeding year based upon *current profits.*

In the Balance Sheet, the amounts provided for taxation should be clearly and separately stated. The outstanding liability for the current fiscal year will be included with current liabilities; the amount set aside for the estimated future liability in the fiscal year commencing after the date of the Balance Sheet (based on current profits) will be shown separately as a Reserve.

It should be noted that this extended provision only applies where

the assessment is based on the income or profits of the preceding year. Provision will be made in the normal way for tax assessed or current year's income, e.g. Sch. A.

The attention of the student is directed to the Recommendations of the Institute of Chartered Accountants on the treatment of taxation in accounts, and also to Chapter XXIII for the requirements of the Companies Act, 1948, in this respect.

Profits Tax. The detailed rules, although based on those relating to Income Tax, differ considerably from them. The assessment is based on profits of the current accounting year and tax is payable within one month of the date of assessment. Provision must be made in the accounts for the Profits Tax liability of the current year and the amount will appear in the Balance Sheet under Current Liabilities. A separate Profits Tax Account may be opened in the books if desired, or the entries may be made, along with those relating to Income Tax, in the Taxation Account. Where possible the charge for Profits Tax should be shown separately from that for Income Tax in the Profit and Loss Account. Similar considerations apply, *mutatis mutandis,* in respect of the Excess Profits Levy.

Tax Reserve Certificates. These certificates are issued for £25 or multiples of that sum by the Treasury to enable taxpayers to set aside funds for the payment of future taxation. They may be used for the payment of Income Tax (except Sch. C tax, tax charged under Sect. 188, Income Tax Act, 1952, and Sch. E tax), Sur-tax, Profits Tax, Excess Profits Levy, or Land Tax deemed due not less than two months from the date of the certificate. To the extent so used they bear interest at the rate of 1½ per cent per annum[1] free of tax, for a maximum period of two years from the date of issue. If the certificates are repaid in cash, no interest is allowed. The following points are important in regard to their treatment in the books—

(1) Tax Reserve Certificates are assets and should therefore appear in a separate account and not in the Taxation Account. In the Balance Sheet they should be shown as a separate item in Current Assets. The double-entry in relation thereto will be—

Debit Tax Reserve Certificates	Credit Cash (on purchase)
Debit Income Tax	Credit Tax Reserve Certificates (on surrender in payment of Income Tax)
Debit Cash	Credit Tax Reserve Certificates (on repayment in cash)

(2) The interest allowed on the certificates should be treated as such and therefore brought ultimately to the credit of Profit and Loss Account, the debit being either to cash, if actually received, or

[1] Certificates of the Second Series issued up to July, 1952, bear interest at the rate of three-quarters of 1 per cent per annum.

to Income Tax Account, if used for the payment of tax. It is regarded as the better practice not to take credit in the accounts for accrued interest unless the certificates have been surrendered before the signing of the Balance Sheet.

Excess Profits Tax Post-war Refunds. Until the passing of the Finance Act, 1953, the payment of such refunds was subject to their being used to develop or re-equip a specified trade or business and no part thereof could be directly or indirectly distributed in any way to the shareholders, partners or proprietors. As far as the accounts were concerned, it was the practice for the refund to appear on the "liabilities" side of the Balance Sheet, shown and maintained separately, as a Capital Reserve. Sect. 32 of the Finance Act, 1953, releases taxpayers from existing undertakings given in order to obtain refunds and provides for future refunds to be paid without further undertakings. For balance sheet purposes, therefore, it is recommended that, except in special circumstances, the E.P.T. Post-war Refund Reserve or Suspense Account should no longer be shown as a separate item, but be merged in the other reserves (capital or revenue, according to whether it is regarded as available for distribution).

Illustration. The Trial Balance of New Delight Ltd. at 31st December, 1953, contained the following—

		£	£
Interim Dividend paid		3,300	
Debenture Interest to 31st December, 1953 (net)		550	
Provision for Taxation at 1st January, 1953			9,452
Investment Income (net)			165
Income Tax paid—			
Schedule D—Case 1, 1952–53—			
Cash	£1,906		
Tax Reserve Certificates and Interest	2,515		
		4,421	
Schedule A, 1952–53: Cash		405	
Profits Tax, 1952, paid in cash		301	
Tax Reserve Certificates		5,000	
Interest on Tax Reserve Certificates			15

The following provisions are, *inter alia*, to be made in preparing the final accounts—

(1) A proposed dividend at the rate of 6 per cent, less tax, payable on 15th March, 1954, on Capital of £100,000.

(2) Taxation:

	£
Schedule D, Case 1: 1953–54	4,325
Schedule D, Case 1: 1954–55	4,050
Schedule A: 1953–54	405
Profits Tax: 1953	2,000

Show the Taxation Account of the company for the year ended 31st December, 1953.

Dr. TAXATION *Cr.*

		£	£			£	£
1953 Jan. 1	To Cash: Sch. D Case I 1952–53	1,906		1953 Jan. 1	By Balance b/d— Sch. D Case I 1952–53	4,421	
	,, Tax Reserve Certificates— Sch. D. Case I 1952–53	2,500			1953–54	4,325	
	,, Interest on Tax Reserve Certificates surrendered in payment of Sch. D Case I 1952–53	15			Sch. A 1952–53	405	
			4,421				9,151
	,, Cash: Sch. A 1952–53		405		Profits Tax, 1952		301
?	,, Cash: Profits Tax, 1952		301	Dec. 31	,, Debenture Interest: Tax recouped		450
Dec. 31	,, Dividends received: Tax deducted		135		,, Profit and Loss A/c— Profits Tax, 1953		2,000
	,, Balances c/d— Sch. D Case I 1953–54	4,325			Sch. D Case I, 1954–55	4,050	
	1954–55	4,050			Sch. A. 1953–54	405	
	Sch A. 1953–54	405			Tax on dividends received	135	
	Profits Tax, 1953	2,000				4,590	
			10,780		*Less* recouped on Debenture Interest	450	
							4,140
			£16,042				£16,042
				1954 Jan. 1	By Balance b/d		10,780

Notes. (1) Since dividends paid and payable are brought into the books net, there will be no reference to them in the Tax Account.

(2) There will be a separate Tax Reserve Certificates Account, which will be credited with £2,500 in respect of the certificates surrendered. The Interest Account will be closed off to Profit and Loss Account.

ACQUISITION OF PROPERTY

Inasmuch as it entails adjustment of income tax, the question of the acquisition of property is dealt with in this chapter.

Upon making an agreement to acquire Land or Buildings it is customary for the purchaser to pay at once 10 per cent of the purchase price, thus enabling him to become entitled to require the formal transfer, i.e. conveyance of the property in question, but there is no *ownership* till date of completion, so that no entry as to purchase should be made until completion (except that relating to the deposit paid). If the purchaser fails to implement his bargain he will forfeit the deposit.

Upon the day being fixed for the conveyance (completion date) the purchaser will have the property transferred to him and pay the Vendor—usually in CASH or by Banker's draft, the balance of the purchase money plus the apportioned *prepayments* less the apportioned *accruals* as at the date of conveyance. Any exceptional item will be dealt with according to circumstances, e.g. if the

property is let to a tenant, the accruing rent will be charged to the purchaser of the property, who will later recoup himself as he will receive rent for a *full* period. For instance, if property is purchased on the 25th November and the tenant pays a quarterly rent of £45, the purchaser will be charged by the vendor with rent for two months, viz. £30, but will receive the full quarter's rent to 25th December, viz. £45, thus receiving on balance £15, which is the amount due to him in respect of his ownership from 25th November to the 25th December.

The principle involved is that the purchaser as new owner assumes the burdens connected therewith, together with the benefits, so that he must, as between himself and the vendor, pay for the benefits, e.g. Fire Insurance prepaid; and obtain credit for the liabilities he is assuming, e.g. unpaid income tax.

Exceptionally, arrangements are made for the vendor to pay the liabilities as at the date of completion, the purchaser being liable only for those arising since such date. Frequently interest is allowed to the purchaser on the deposit from the date of payment.

The completion is accompanied by an Apportionment Account drawn up to the date of completion in account form or an Apportionment Statement drawn up in tabular form.

The heading may be (1) Vendor in account with the Purchaser representing the entries that would appear in the books of the purchaser, or (2) Purchaser in account with the Vendor representing the entries that would appear in the books of the vendor, viz. in (1):

Debit *Vendor*	Credit Cash
Debit Property	Credit *Vendor*
Debit Prepayments	Credit *Vendor*
Debit *Vendor*	Credit Accrued or accruing liabilities

The items in italics appear in the Apportionment Account.

Illustration. Purchaser acquires property from Vendor at £1,500 paying 10 per cent deposit, completion to be made on 31st October, 1953.

From the following information prepare Apportionment Account heading it "Purchaser in account with Vendor," and journalize the opening entries in the books of the purchaser.

General Rates are 11s. in £ on a rateable value of £100, the vendor having paid one-half on account. Water Rates are £6 per annum, the vendor having paid £3 on account. Chief Rent is £12 per annum, payable half yearly: 30th June and 31st December, paid by the vendor to 30th June, 1953. Net annual value for Income Tax is £80. Insurance is £2 per annum paid by Vendor to 30th April, 1954. The financial year of the Rating Authority ends at 31st March. Ignore Interest, Solicitor's charges, and Transfer Duties, and calculate in months. Take Income Tax at 9s. in the £.

Apportionment Account made up to date of Completion 31st October, 1953

Dr. Purchaser in account with Vendor **Cr.**

	£	s.	d.			£	s.	d.
To Purchase Money	1,500	0	0	By Deposit		150	0	0
,, Insurance paid to 30th April, 1954—Six months at £2 per annum[1]	1	0	0	,, General Rates owing from 1st April, 1953 to date at £55 per annum—				
				Seven months	£32 1 8			
				Less paid on account	27 10 0	*4	11	8
				,, Water Rate owing from 1st April, 1953 to date at £6 per annum—				
				Seven months	£3 10 0			
				Less paid on account	3 0 0		10	0
				,, Chief Rent owing from 1st July, 1953 to date at £12 per annum—				
				Four months	£4 0 0			
				Less Income Tax at 9s. in £	1 16 0	2	4	0
				,, Sch. A Income Tax, accruing from 6th April, 1953 to date at 9s. in £—[Net Annual Value £80] Seven months, i.e. $\frac{7}{12}$ of	£36 0 0	21	0	0
				,, Balance, due to Vendor		1,322	14	4
	£1,501	0	0			£1,501	0	0

* As the date of purchase is one month after the end of the half-year, to which date the Vendor has paid the Rates, there is one month outstanding against him, i.e. $\frac{1}{12} \times$ £55 = £4 11s. 8d.

The opening Journal entries of the purchaser, ignoring narratives, are—

Journal

		£	s.	d.	£	s.	d.
Vendor . . . . . *Dr.*		150	0	0			
To Cash					150	0	0
Property . . . . . *Dr.*		1,500	0	0			
Insurance . . . . . *Dr*		1	0	0			
To General Rates					4	11	8
,, Water Rate						10	0
,, Chief Rent					2	4	0
,, Income Tax					21	0	0
,, Vendor					1,472	14	4
Vendor . . . . . *Dr.*		1,322	14	4			
To Cash					1,322	14	4

[1] In certain districts this is calculated from date of signing contract; in other districts from date of assignment of the policy.

Strictly, the position relating to insurance on a sale of property must be consistent with Sect. 47 Law of Property Act, 1925, which provides that where after the date of the contract of sale moneys become due from an insurance company for damage to or destruction of the property, on completion, such money belongs to the purchaser, provided that there is the requisite consent of the insurers and that the purchaser pays his due proportion of the premium from the *date of the contract*. The contract, however, may stipulate other arrangements.

Illustration. X purchased property for £1,000 on 1st November, 1953, subject to a chief rent of £24 paid to 30th June, 1953. The net annual value is £64. Show how the tax (9s. in the £) will be dealt with in X's accounts made up to 30th April, 1954.

Upon purchasing the property, X will require to be credited by the vendor with (to nearest month) 7 months' income tax from 6th April, 1953, to 1st November, 1953, because as occupier he will, on 1st January, 1954, be liable for the FULL year's tax, so that he will himself bear the tax for the twelve months to 5th April, 1954, less tax for seven months debited to the vendor, i.e. five months in all, which is the period of occupation in 1953–54, viz. from 1st November, 1953, to 5th April, 1954. The amount to be debited to the vendor is $\frac{7}{12} \times \frac{9}{20} \times$ £64 = £16 16s.

On 1st November, 1953, four months' chief rent is accruing, viz. £2 a month = £8, but as this is subject to a deduction of tax, it will be reduced to £4 8s., i.e. £8 less tax at 9s. thereon. On 31st December, 1953, X will pay the half year's chief rent of £12, less tax of £5 8s. This means that he receives credit from the vendor of £4 8s. and pays £6 12s., i.e. he bears the net sum of £2 4s., which is for the period of his occupancy from 1st November to 31st December at £2 a month, viz. £4 less tax at 9s. in £.

The accounts are shown on pages 548 and 549.

As income tax will be debited to Drawings there will usually be no provision for tax accruing—in any case his liability for Case I, Schedule D, 1953-54 (if any), will normally be based upon the adjusted profit to 30th April, 1952.

It must be recollected that the *whole* Schedule A tax is payable notwithstanding the burden of chief rent, so that when paying the latter the owner is able to recoup himself for tax. In normal years, assuming tax at 9s., the owner will incur a liability of[1]—

	£	s.	d.
£64 at 9s. in £ . . . . =	28	16	0
but will recoup Income Tax at 9s. in the £ on Chief Rent £24 =	10	16	0
leaving a final burden of £40 at 9s. . . . . . =	18	0	0

This corresponds with the result shown on page 549 which is £9, as the period in question is six months from date of purchase (1st November, 1953, to 30th April, 1954) i.e. half a normal year.

[1] If his income, after allowances, is liable at reduced rates, the Schedule A will be £40 at reduced rates plus £24 at full standard rate.

Vendor of Property

Dr.			£	s.	d.				Cr. £	s.	d.
1953 Nov. 1	To Cash: Deposit . . .		100	0	0	1953 Nov. 1	By Property: Purchase Price .		1000	0	0
	,, Proportion of Sch. A. 7 months on £64 at 9s. in the £ from 6th April 1953 to date. .		16	16	0		,, Income tax on Chief Rent .		3	12	0
	,, Proportion of Chief Rent 4 months at £24 per annum from 1st July 1953 to date .		8	0	0						
	,, Cash		878	16	0						
			£1,003	12	0				£1,003	12	0

Chief Rent

Dr.			£	s.	d.				Cr. £	s.	d.
1953 Dec. 31	To Cash: half-year's Chief Rent £12 *Less* Income Tax at 9s. £5 8s.		6	12	0	1953 Nov. 1	By Vendor—Chief Rent accruing to date		8	0	0
	,, Income Tax Account—Income Tax on Chief Rent .		5	8	0	1954 April 30	,, Profit and Loss Account (i.e. Chief Rent for 6 months from 1st Nov., 1953 to date, at £24 per annum) . . .		12	0	0
1954 April 30	,, Do. Do.		3	12	0						
	,, Provision for 4 months' Chief Rent . . £8 *less* Income Tax at 9s. 3 12s.	c/d	4	8	0						
			£20	0	0				£20	0	0
						May 1	By Balance	b/d	4	8	0

Dr. **INCOME TAX** Cr.

Date	Particulars	Fo.	£	s.	d.	Date	Particulars	Fo.	£	s.	d.
1953 Nov. 1	To Vendor—Income Tax on Chief Rent		3	12	0	1953 Nov. 1	By Vendor—Sch. A Tax on property		16	16	0
1954 Jan. 1	,, Cash—Sch. A Tax on property £64 at 9s. in the £		28	16	0	Dec. 31	,, Chief Rent— Income Tax thereon		5	8	0
April 30	,, Provision for Sch. A: 1 month from 6th April, 1954, to 30th April, 1954, $\frac{1}{12}$ × £28 16s.	c/d	2	8	0	1954 April 30	,, Do. Do.		3	12	0
							,, Drawings Account[1]		9	0	0
			£34	16	0				£34	16	0
						May 1	By Balance	b/d	2	8	0

	£	s.	d.
[1] This is made up of liability—			
(1) Sch. A Tax 1st Nov., 1953, to 30th April, 1954—six months at £28 16s. per annum (£64 at 9s.)	14	8	0
(2) *Less* Income Tax on Chief Rent recouped and recoupable: 1st Nov., 1953, to 30th April, 1954—six months at £24 per annum (£12 at 9s.)	5	8	0
	£9	0	0

CHAPTER XXII

PARTNERSHIP ACCOUNTS

Section (A) General Principles and Division of Profits

It is not within the scope of this work to attempt a complete analysis of Partnership Law, but to consider it only in so far as it relates to Accounting. Partnership Accounts call for a knowledge of law as laid down in the Partnership Act, 1890, and in decided Cases, but the principles of accounting are basically similar to those applying to a sole trader.

The following legal points relating to partnership have a direct bearing upon accounting and are of extreme importance—

(1) The definition of Partnership as laid down in the Act is: "*Partnership is the relation which subsists between persons carrying on a business in common with a view of profit.*" [1]

(2) No statutory books are required, nor is any creditor or other outside person entitled to inspect the partnership accounts, except by the consent of the partners, nor are accounts required to be filed with any Government department, nor are any formal returns necessary, except—

(*a*) a Limited Partnership must be registered;

(*b*) a firm name which does not consist of the true surnames of all the partners without any addition except the Christian names or the initials or recognized abbreviation, must be registered under the Registration of Business Names Act, 1916;[2]

(*c*) returns required by and right of inspection of accounts given to officials of—

(i) Customs and Excise in respect of Purchase Tax,

(ii) the Inland Revenue under the system of P.A.Y.E.

In practice accounts will have to be submitted to the Inland Revenue in support of the partners' Income Tax Returns.

(3) The partners may make such arrangements as they wish for the purpose of regulating the rights, duties, and powers as between themselves.

(4) The arrangements may be formulated in a deed; or in a written document signed by the partners; or even orally. In addition there may be an implied variation of the original agreement ascertainable by a course of dealing.

It should be noted that if any matter is not dealt with in the agreement, the relevant provisions of the Partnership Act, 1890, will apply. It is quite possible, though in most cases not advisable, for a partnership to exist without any agreement (except merely that the

[1] No more than twenty persons (in the case of banks ten) are permitted to be associated in partnership. Sects. 429 and 434 Companies Act, 1948.

[2] The Act applies similarly to an individual carrying on a business.

parties have agreed to work in partnership, and to be bound only by the provisions of the Act). Variation of an agreement, by a course of dealing is frequently met with, e.g. if the partnership agreement provides that a partner shall be permitted to withdraw £400 yearly, and with consent of the other partner he withdraws £500, the original agreement to this extent is altered by a course of dealing.

The accounting provisions of the Act, which must be applied in working all partnership problems, unless information to the contrary is given, are—

Sect. 19. The mutual rights and duties of partners, whether ascertained by agreement or defined by this Act, may be varied by the consent of all partners, and such consent may be either express or inferred from a course of dealing.

Sect. 24. The interests of the partners in the partnership property and their rights and duties in relation to the partnership shall be determined, *subject to any agreement, express or implied,* between the partners, by the following rules—

(1) All the partners are entitled to share equally in the capital and profits of the business, and must contribute equally towards the losses, whether of capital or otherwise, sustained by the firm.

(2) The firm must indemnify every partner in respect of payments made and personal liabilities incurred by him—

(*a*) In the ordinary and proper conduct of the business of the firm; or

(*b*) In or about anything necessarily done for the preservation of the business or property of the firm.

(3) A partner making, for the purpose of the partnership, any actual payment or advance beyond the amount of capital which he has agreed to subscribe, is entitled to interest at the rate of 5 per cent per annum from the date of the payment or advance.

(4) A partner is not entitled, before the ascertainment of profits, to interest on the capital subscribed by him; even if interest on Capital is agreed upon, it ceases on dissolution (*Watney* v. *Wells*).

(5) Every partner may take part in the management of the partnership business.

(6) No partner shall be entitled to remuneration for acting in the partnership business.

(7) No person may be introduced as a partner without the consent of all existing partners.

(8) All differences arising as to ordinary matters connected with the partnership business may be decided by a majority of the partners, but no change may be made in the nature of the partnership business without consent of all existing partners.

(9) The partnership books are to be kept at the place of business of the partnership (or the principal place, if there is more than one), and every partner may, when he thinks fit, have access to and inspect and copy any of them.

As far as the accounts are concerned, the most important clauses of the above are (1), (3), (4), and (6), and all students must obtain a thorough grasp of them.

In reference to (3), no interest (unless agreed upon) is chargeable to a partner for loans or advances *by* the firm *to* him.

Sect. 42. This section deals with the right of a retiring partner to receive interest or share in the profits made after the dissolution of the partnership.

(1) Where any member of a firm has died or otherwise ceased to be a partner, and the surviving or continuing partners carry on the business of the firm with its capital or assets without any final settlement of accounts as between the firm and the outgoing partner or his estate, then, in the absence of any agreement to the contrary, the outgoing partner or his estate is entitled at the option of himself or his representatives to such share of the profits made since the dissolution as the **Court** may find to be attributable to the use of his share of the partnership ASSETS, *or* to interest at the rate of 5 per cent per annum on the amount of his share of the partnership ASSETS.

(2) Provided that where, by the partnership contract, an option is given to surviving or continuing partners to purchase the interest of a deceased or outgoing partner, and the option is duly exercised, the estate of the deceased partner, or outgoing partner or his estate, as the case may be, is not entitled to any further or other share of profits; but, if any partner assuming to act in exercise of the option does not in all material respects comply with the terms thereof, he is liable to account under the foregoing provisions of this section.

Where an account of the profits is ordered, the Court may make an allowance to the continuing partner for carrying on the business.

Even if the partnership agreement provides that the share of an outgoing partner should be ascertained by reference to the next annual account, the assets of the firm, in the absence of evidence or any uniform usage to the contrary, must be taken at their **fair value** at the date of the account, and not at the value appearing in the books (*Cruikshank* v. *Sutherland*). This includes the asset goodwill, and may involve a complete revaluation (up or down) of assets and liabilities. In other words, the book values of assets and liabilities are ignored, and their fair values substituted. This does not necessarily involve permanent alterations of values in the books, as will be shown later; but the revised figures form the basis of computing the share of the outgoing partner.

Sect. 43. *Subject to any agreement between the partners*, the amount due from surviving or continuing partners to an outgoing partner, or the representatives of a deceased partner in respect of the outgoing or deceased partner's share, is a debt accruing at the date of the dissolution or death. Thus, the liability of the surviving or continuing partners will depend on the partnership agreement, but otherwise the amount due to the retiring partner is a debt accruing

at the date of dissolution (or death), and such is the relevant date for the purpose of the Limitation Act, 1939.

Sect. 44 of the Act deals with the rules for the distribution of the assets on dissolution, both when there is a surplus and when there is a deficiency.

(*a*) Losses, including losses and deficiencies of capital, shall be paid first out of profits, next out of capital, and lastly, if necessary, by the partners individually in the proportion in which they were entitled to share profits—

(*b*) The assets of the firm including the sums, if any, contributed by the partners to make up losses or deficiencies of capital, shall be applied in the following manner and order—

(i) In paying the debts and liabilities of the firm to persons who are not partners therein.

(ii) In paying to each partner rateably what is due from the firm to him for *advances* as distinguished from capital.

(iii) In paying to each partner rateably what is due from the firm to him in respect of capital.

(iv) The ultimate residue, if any, shall be divided among the partners in the proportion in which profits are divisible.

It should be observed that an advance by the firm to the partner is a debt which the latter must either discharge in cash, or which (if no question of deficiency of assets arises) may be set off against the capital and profits due to such partner. In a dissolution, costs of dissolution must be met before moneys are available for partners.

Although the partnership agreement may provide an alternative method of distribution between the partners themselves, it cannot take away the rights of third parties to be paid in due priority.

Where, after a dissolution one of the partners has, after the final realization of assets and part settlement of liabilities, a deficiency of capital which he is unable wholly to make good, such deficiency is a loss which must be borne by the partners as laid down in *Garner* v. *Murray*, a decision which has received much adverse criticism. It was laid down in this case that such loss must be borne by the solvent partners, not as they share ordinary profits and losses, but in proportion to their last agreed capitals. The interpretation of "last agreed capitals" often causes difficulty. The matter is dealt with in detail in Section H. (pp. 708 *et seq.*)

The Limited Partnership Act, 1907. There are no provisions in this Act relating to the actual book entries, the most important point being, for the purpose of this book, the definition of a limited partner.

This is defined by Sect. 4 (2) of the Limited Partnership Act, 1907, as—

A limited partnership shall not consist, in the case of a partnership carrying on the business of banking, of more than ten persons,

and in the case of any other partnership, of more than twenty persons, and must consist of one or more persons called general partners, who shall be liable for all debts and obligations of the firm, and one or more persons to be called limited partners, who shall at the time of entering into such partnership contribute thereto a sum or sums as capital or property valued at a stated amount, and who shall not be liable for the debts or obligations of the firm beyond the amount so contributed.

Sect. 4 (3) A limited partner shall not during the continuance of the partnership, either directly or indirectly, draw out or receive back any part of his contribution, and if he does so draw out or receive back any such part, shall be liable for the debts and obligations of the firm up to the amount so drawn out or received back.

(4) A body corporate may be a limited partner.

The essential differences between a general partnership and a limited partnership should be learnt from a legal textbook, and particular attention should be paid to the following matters—

(i) Registration of the limited partnership (no limited partnership exists UNTIL REGISTRATION).
(ii) Registration of the changes in personnel.
(iii) Effect of lunacy or death of limited partner.
(iv) Effect of assignment by limited partner.
(v) Right of inspection of books by limited partner.
(vi) Right of the limited partner to ADVISE, but not to participate in the MANAGEMENT.

Summary. Summarized, the chief legal points appropriate to partnership accounting may be stated thus—

(1) Partners are entitled to share profits equally, and must likewise bear losses equally irrespective of the amount of their respective Capital Accounts, unless otherwise agreed.

(2) Partners are entitled neither to interest on capital nor to salaries, unless otherwise agreed.

(3) Partners who advance money (or other assets) beyond the amount of their capitals *are* entitled to charge interest thereon, at the rate of 5 per cent per annum, unless otherwise agreed.

(4) No interest is charged to partners in respect of their drawings (or advances by the firm), unless otherwise agreed.

(5) Any increase or decrease in the value of an asset or liability is, as the case may be, a profit or loss, and all partners participate in the profit or bear the loss equally in the absence of agreement, or otherwise as the agreement provides.

(6) A partnership agreement may be constituted (*a*) by deed, (*b*) by writing, (*c*) by word of mouth. It may be varied by a COURSE OF DEALING.

(7) Generally, an outgoing partner is entitled to have his proper share of the **net** assets (i.e. assets less liabilities), including GOODWILL, as they exist at the date of his retirement, quite apart from the values placed on them in the books. This may involve a revaluation and readjustment of accounts.

(8) Although in proper cases a partner is entitled to be indemnified for expenses properly incurred, it must be remembered that he will inevitably bear a proportion of such expenses, so that consequently such indemnity is in reality only partial.

(9) Finally, the student should thoroughly assimilate Sects. 19, 24, 42, and 44 of the Partnership Act, 1890.

Partnership Agreement. In the majority of instances partners will have drawn up a written agreement, the exact terms of which will depend upon circumstances, but, generally speaking, provision will be made to cover the undermentioned points—

(1) The firm name and the business to be carried on under that name.

(2) Business address or addresses.

(3) Commencement and duration of the partnership.

(4) Whether, and in what circumstances, notice of retirement can be given by a partner.

(5) The Capital (whether fixed or otherwise) and the contribution of each partner.

(6) Provision for further capital and loans by partners to the firm.

(7) Partners' Drawings.

(8) Interest on Capital, loans, drawings and Current Accounts.

(9) Partners' Salaries, commissions and other remuneration.

(10) Division of profits and losses.

(11) The keeping of proper books of account, inspection and audit. Bank Accounts.

(12) The date to which accounts are to be drawn up and the period of accounts. Signatures of partners to Balance Sheets.

(13) Conduct, powers and duties of partners.

(14) Income Tax and Sur-tax.

(15) Provision that death or retirement of a partner shall not, as regards the remaining partners, dissolve the partnership.

(16) Dissolution and Winding Up provisions with special regard to the valuation of Goodwill. Manner and date of payment of the share due to a deceased or retired partner, and manner in which such moneys may be provided for during the partnership, e.g. Assurance policies.

(17) Nomination by partners of successors and the introduction of sons and other near relatives.

(18) Formulae for valuation of assets (and liabilities), including goodwill, on the death or retirement of a partner; whether, if a partner retires, as distinct from his decease, he is entitled to *any* goodwill.

(19) Provision in exceptional and serious circumstances for partners to expel an offending partner.

(20) Provision for the position arising through absence on account of ill-health or other justifiable cause.

(21) Provision for the position arising on the sale of the business to a limited company.

(22) The settlement of disputes, e.g. arbitration.

Partnership Accounts

Upon commencement of the study of partnership accounts a student usually approaches it under the impression that a departure from the ordinary principles of book-keeping is entailed. Such is not the case; for, allowing for different circumstances that must necessarily arise in partnership accounts as compared with sole traders' accounts, a student will follow in the ordinary way the elementary principles he has already acquired, e.g. the closing of the Profit and Loss Account involves a debit to that account and a credit to Capital. As, however, there will be more than one participant in the profits and more than one Capital Account, it is necessary to know in what ratio the profits are shared, so that each partner's Capital Account may be credited with the appropriate share.

In order that the partners may know what is the amount of their respective interest in the firm, it is clearly of the greatest importance that a proper system of accounting should be in force.

It will be apparent that most of the problems peculiar to partnership accounts have some connection with the ascertainment of the amount of each partner's share in the profits and in the assets, both during the continuance of the partnership and upon death or dissolution. As the student proceeds in his study he will realize that most of the problems have some relation to these points. In the elucidation of such problems—some of which are rather involved in their detail—there will be involved the application of partnership law, the principles of ordinary arithmetic, and the practice of business men.

The following decided cases which have a bearing on the accounts should be noted—

(1) Persons who share net profits and losses are prima facie partners (*Walker* v. *Hirsch*).

(2) Although interest on Capitals has been agreed upon, it ceases on dissolution (*Watney* v. *Wells*).

(3) Unless the Partnership agreement forbids, a partner may carry on a non-competing business so long as he does not represent it to be that of the firm, notwithstanding that the knowledge he possesses as a partner may, and his connection with the firm will, be of material use in his other business (*Aas* v. *Benham*). Further it may even be a *similar* business provided that it is non-competitive. (*Trimble and Bennett* v. *Goldberg*).

(4) An assignee of a partner's share in a partnership will be bound by any *bona fide* agreement between the partners and would not be able to object to the remaining partners taking a salary on account of the extra work falling upon them. (*Garwood* v. *Poynter.*)

(5) Goodwill, although omitted from a Balance Sheet, must be taken into account on dissolution and every partner is entitled to have it sold for the benefit of *all* the partners. (*Turner* v. *Major.*)

(6) The omission of Goodwill from the books is not to be regarded as a "course of dealing" so as to prevent its being dealt with as a partnership asset for the common benefit of all the partners. (*Barrow* v. *Barrow.*) If, however, the Partnership Articles provide that the last annual account shall be the *final* account on dissolution, this will bind, in the absence of fraud, all the partners. (*Stewart* v. *Gladstone.*)

(7) Where, under Section 42, the option to take profits is exercised, the Court will usually grant reasonable remuneration to the continuing partners (*Brown* v. *de Tastet*), unless they themselves are the personal representatives of the deceased partner. (*Stocken* v. *Dawson.*)

(8) Where a partner's estate is entitled to Goodwill on *death* but a partner is not so entitled on terminating the partnership by *notice*, and death occurs *after* notice has been given but *before* it reaches the firm, the dissolution is deemed to arise by *death* and not by notice, so that goodwill is payable. (*McLeod* v. *Dowling.*)

Partners' Accounts

The normal "proprietorship" accounts in a partnership will be (*a*) Capital, (*b*) Current, (*c*) Drawings accounts for EACH partner; whilst in addition, circumstances may call for (*d*) Interest accounts, and (*e*) Loan accounts for one or more partners.

Each account will be dealt with separately.

(*a*) **Capital Account.** The amounts contributed by each partner whether in cash or in other assets, will be credited to his Capital Account, and unless partners agree otherwise, this account remains intact during the continuance of the partnership, as the presumption in partnership law is that the Capital Account of each partner is **fixed**, thus involving the burden on each partner to restore his capital to its original level where his drawings exceed his share of profits, or where losses occur or losses are accompanied by drawings. This restoration is rarely made, as a separate account—described as a Current Account—is opened in respect of each partner to record the position of each partner *vis-à-vis* the firm otherwise than in relation to his capital. Yet, if partners are agreed, profits, losses and drawings may be entered in the Capital Accounts without the utilization of the Current Accounts. It is, however, important to remember that if a partner makes an advance to the firm, whether by way of money or otherwise, the amount should be

credited to that partner's Loan Account, as such advance attracts interest at the rate of 5 per cent per annum, unless the partners otherwise agree.

Should the partners decide upon the employment of a Capital Account only for each partner it will usually contain items as illustrated below—

Dr. A. JOHNSON CAPITAL *Cr.*

			£				£
19.. June 30	To Cash (Drawings) (*Cr.* Cash)		400	19.. Jan. 1	By Balance	b/d	2,000
Aug. 31	,, Cash (Drawings) (*Cr.* Cash)		300	Dec. 31	,, Interest on Capital (*Dr.* Profit and Loss)	[1]	100
Dec. 31	,, Interest on Drawings (*Cr.* Profit and Loss)	[2] [1]	15		,, Profit & Loss Account: ⅓ share of Profits (*Dr.* Profit and Loss)	[1]	750
	,, Balance	c/d	2,135				
			£2,850				£2,850
				19.. Jan. 1	By Balance	b/d	2,135

The above illustration assumes that partners are entitled to interest at 5 per cent per annum on their capitals as at the beginning of the year, and are charged at the same rate of interest on drawings from the date of the withdrawal to the end of the accounting period. If the items are numerous, interest will be computed by means of an additional column on the lines of an account current.

In the following year, interest on capital will be calculated on the "merged" balance £2,135.

(*b*) **Current Account.** In order to preserve the original capital intact, subject to further agreed contributions and special withdrawals of capital, a separate account may be employed. This is termed a Current Account, and will contain on the debit side drawings and interest on drawings (if any), and on the credit side interest on capital (if any), and the two items below—

(1) Opening and closing balance which may be debit or credit.

(2) Transfers from Profit and Loss Account which will be (*a*) debit for loss, and (*b*) credit for profit.

Interest may also be debited or credited on the balance of the Current Account itself.

Illustration. Using the same facts as shown in the preceding illustration, the position of A. Johnson, assuming £500 appears as the balance of his Current Account, will be recorded as follows—

Dr. A. JOHNSON CAPITAL *Cr.*

							£
				19.. Jan. 1	By Balance	b/d	1,500

[1] Strictly Profit and Loss Appropriation Account.

[2] See note 1, page 559.

Dr. A. JOHNSON CURRENT ACCOUNT *Cr.*

Date	Particulars		£	Date	Particulars		£
19..				19..			
June 30	To Drawings . . .		400	Jan. 1	By Balance . . .	b/d	500
Aug. 31	" " . . .		300	Dec. 31	" Interest on Capital .		75[2]
Dec. 31	" Interest on Drawings .		15[1]		" Interest on Current Account . .		25[3]
	" Balance . . .	c/d	635		" Profit and Loss Account: ½ share of Profits . . .		750
		£	1,350			£	1,350
				19.. Jan. 1	By Balance . . .	b/d	635

The combined balances are £2,135, as in the preceding illustration. This must be so because the interest allowed is upon the Capital (£1,500) and the Current Account (£500). It must be noted that there would be no interest on either account unless the partners so agreed.

(*c*) **Drawings Account.** This account will be almost self-explanatory inasmuch as partners may regularly withdraw sums from the business, and as a result, the Current Account would become congested with a large number of entries. By opening a Drawings Account (with an interest calculation column if necessary) all the detailed withdrawals may be recorded in this account, the total thereof being transferred to the debit of the Current Account in the one sum at the end of the accounting period; whilst the interest thereon (if any) will be debited (1) to Current Account and credited to Profit and Loss Account, or (2) to Drawings Account and transferred in one figure with the drawings to the debit of the Current Account, or (3) debited to the partner's Interest Account.

(*d*) **Interest Account.** Where it is desired to have separately recorded the interest charged and credited to each partner an Interest Account is opened in the name of each partner. The entries for interest due to the partner are: debit Profit and Loss Account, and credit the partner's Interest Account; whilst the opposite entries are made for interest due by the partner. The balance of the account will be transferred to the partner's Current Account.

Again, the student is reminded that there is no interest to or against a partner except (1) in respect of advances by a partner, or (2) by AGREEMENT.

Illustration. In reference to the preceding example, Johnson's accounts will, utilizing Interest and Drawings Accounts, appear thus—

Dr. A. JOHNSON CAPITAL *Cr.*

Date	Particulars		£	Date	Particulars		£
				19.. Jan. 1	By Balance . . .	b/d	1,500

		£	£
[1]	£400 at 5% per annum for 6 months (1st July to 31st Dec.) .	£10	
	£300 at 5% per annum for 4 months (1st Sept. to 31st Dec.) .	5	
			15
[2]	£1,500 at 5% per annum for 12 months (1st Jan. to 31st Dec.)		75
[3]	£500 at 5% per annum for 12 months (1st Jan. to 31st Dec.) .		25

Dr. A. JOHNSON CURRENT ACCOUNT *Cr.*

19.. Dec. 31	To Drawings . . .		£ 700	19.. Jan. 1	By Balance . . .		£ 500
	,, Balance . . .	c/d	635	Dec. 31	,, Interest Account .		85
					,, Profit and Loss Account: ½ share of Profits . .		750
			£1,335				£1,335
				19.. Jan. 1	By Balance . .	b/d	635

Dr. A. JOHNSON INTEREST *Cr.*

19.. Dec. 31	To Interest on Drawings .		£ 15	19.. Dec. 31	By Interest on Capital Account . .		£ 75
	,, Current Account .		85		,, Interest on Current Account . .		25
			£100				£100

Dr. A. JOHNSON DRAWINGS *Cr.*

			Mos.	Interest	Principal				Mos.	Interest	Principal
19.. June 30	To Cash .		6	£ 10	£ 400	19.. Dec. 31	By Current Account			£	£ 700
Aug. 31	,, ,, .		4	5	300		,, Interest, *per contra*			15	
				£15	£700					£15	£700

It should be remembered that the interest column in the Drawings Account is purely for calculation purposes, and the double entry must be completed by crediting Profit and Loss Account direct, or by crediting Interest on Drawings Account, and subsequently transferring the balance of this account to the credit of Profit and Loss Account.

(*e*) **Loan Account.** This account calls for no special comment, except that the interest thereon is treated usually like interest on capital and on drawings by the appropriate entries into the Current Account or Interest Account of the partner making the advance.

Withdrawal of Goods. It should be noted that where a partner withdraws goods, his Current Account or Capital Account, as the case may be, will be debited and Purchases Account credited, as it is usual to permit the withdrawal at cost price.

Two other matters require treatment at this stage, viz. (*a*) Partners' Salaries, and (*b*) Interest on Capital.

(*a*) **Partners' Salaries.** Circumstances frequently arise in partnership affairs necessitating the allowance to a partner of an extra share in the profits of the firm because of extraordinary circumstances, e.g. absence of another partner. This is often effected by giving the partner upon whom the additional burden has fallen a salary. This may be dealt with in any of the following ways—

(1) If the salary is paid in cash the double entry is similar to that for any salary, i.e. debit partner's Salary Account and credit cash, the balance on the former account being transferred to the Profit and Loss Appropriation Account at the end of the year.

(2) Where the partner withdraws amounts at irregular intervals, the total salary should be debited to Profit and Loss Appropriation Account and credited to the partner's Salary Account, and on withdrawal of the whole or part, the partner's Salary Account should be debited and cash credited.

In the latter instance, interest may or may not be allowed on the balance standing to the credit of partners' Salary Accounts. Any balance standing on a partner's Salary Account at the end of the year should be transferred to either his Current or his Drawings Account.

(*b*) **Interest on Capital.** Save by certain statutes and certain exceptional rules of equity, a debt does not carry interest, so that in partnership no partner is entitled to, nor is *prima facie* bound to be charged with, interest unless there is an advance by the partner, or an agreement permitting interest. But in order to give a partner a "return" for his investment an agreement is usually made to allow interest on capital, the justice of which is apparent if the capital contributions are highly disproportionate, e.g. where there are two partners, one of whom contributes capital to the extent of £10,000, and another of only £500. This adjustment is, however, an APPROPRIATION of profits—it represents such share of the profits as is attributable to the use of capital, and, in fact, forms a SPECIAL division of profits. Thus, even assuming profits and losses are shared equally, if capitals are UNEQUAL and interest on capital is provided for, the partners in reality do not share all the profits and losses equally because the first "share" thereof depends on capitals and must be divided in capital ratios, and only the **residue** can properly be considered available for division in equal shares: the smaller this residue, the more does the true profit-sharing ratio depart from an equal-sharing basis.

Illustration. A and B are partners with capitals of £5,000 and £600 respectively. The partnership agreement provides for 5 per cent interest on capital, and for the balance of profits to be shared equally. The trading profits are £500 for the year.

Show the distribution of profits as between the partners, both in the ordinary form of account to be headed Profit and Loss Appropriation Account, and in statement form.

The distribution will be—

	£	£
Interest on Capital—		
A—5% on £5,000	250	
B—5% on £600	30	
		280
Balance of Profits—		
A—½ of £220	110	
B—½ of £220	110	
		220
Total . .		£500

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT Cr.

		£	£			£
To Interest on Capital				By Balance . .	b/d	500
A . . .		250				
B . . .		30				
			280			
„ Balance of Profits						
A—½ . .		110				
B—½ . .		110				
			220			
			£500			£500

Where there are not sufficient profits to cover interest on capital, the general opinion is that in the absence of a clear agreement to the contrary, the partners are entitled only to such interest as will just absorb the profits. Otherwise, provision for the full interest would involve the firm in a loss.

Illustration. A and B are partners with capitals of £3,000 and £1,000. They agree to allow interest on capital at the rate of 5 per cent per annum, and to share profits and losses equally. The profits for the year before charging their interest are £160. Show the Profit and Loss Appropriation Account.

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT Cr.

		£			£
To Interest on Capital—			By Balance . . .	b/d	160
A . .	£120				
B . .	40				
		160			
		£160			£160

Otherwise,

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT Cr.

		£			£
To Interest on Capital—			By Balance . . .	b/d	160
A . .	£150		„ Loss—		
B . .	50		A—½ . .	£20	
		200	B—½ . .	20	
					40
		£200			£200

The following illustration embodies the principles outlined so far.

Illustration. J. Caesar and M. Antony are in partnership sharing profits and losses equally. J. Caesar's capital is £5,000; M. Antony's, £1,000. M. Antony is entitled to be *paid* a partnership salary of £300 per annum; J. Caesar, in addition to the above, made a loan to the firm of £2,000 (before 1st January, 19..) on which interest is to be allowed at 5 per cent per annum. Profits for the year to 31st December, 19.., were £3,000, *after* charging up salary, interest on loans and interest on drawings. Interest at 10 per cent per annum is to be charged on drawings, which were as follows—

	J Caesar	M Antony
19..	£	£
Mar 31	240	120
June 30	360	60
Sept 30	240	120
Dec 31	240	360

Show the partners' Capital Accounts, Loan Accounts, Current Accounts, and Drawings Accounts.

Dr CAPITAL *Cr*

			J Caesar	M Antony				J Caesar	M Antony
					19 Jan 1	By Balances	b/d	£ 5,000	£ 1,000

Dr. J CAESAR—LOAN *Cr.*

				19 Jan 1	By Balance	b/d	£ 2,000

(See also following pages)

The average due date method of computing interest might be employed—

J Caesar — Interest on Drawings

£	Mos.	£
240 ×	9 =	2,160
360 ×	6 =	2,160
240 ×	3 =	720
£840		£5,040

∴ Average date of drawings $\frac{5,040}{840}$ = 6 months from 31st Dec = 30th June.

Interest on £840 for 6 months at 10% per annum = £42.

The calculation for M. Antony will be made similarly.

Dr. J. Caesar—Drawings **Cr.**

		Mos.	Int.				
19..			£	£	19..		£
Mar. 31	To Cash .	9	18	240	Dec. 31	By Transfer to Current Account .	1,122
June 30	,, ,, .	6	18	360			
Sept. 30	,, ,, .	3	6	240			
Dec. 31	,, ,, .			240			
	,, Interest Account .			42			
				£1,122			£1,122

Dr. M. Antony—Drawings **Cr.**

		Mos.	Int.				
19..			£	£	19..		£
Mar. 31	To Cash .	9	9	120	Dec. 31	By Transfer to Current Account .	675
June 30	,, ,, .	6	3	60			
Sept. 30	,, ,, .	3	3	120			
Dec. 31	,, ,, .			360			
	,, Interest Account .			15			
				£675			£675

Dr. Current Accounts **Cr.**

			J. Caesar	M. Antony				J. Caesar	M. Antony
19..			£	£	19..			£	£
Dec. 31	To Drawings .		1,122	675	Dec. 31	By Interest on Loan .		100	
	,, Balances .	c/d	478	825		,, Profit and Loss Appropriation Account .		1,500	1,500
			£1,600	£1,500				£1,600	£1,500
					19.. Jan. 1	By Balances .	b/d	478	825

Dr. Profit and Loss Appropriation Account **Cr.**

19..			£	£	19..				£
Dec. 31	To J. Caesar—Loan Interest			100	Dec. 31	By Balance .	b/d		3,343
	,, M. Antony—Salary .			300		,, Interest on Drawings			57
	,, Net Profit—J. Caesar: one-half .		1,500						
	M. Antony: one-half .		1,500						
				3,000					
				£3,400					£3,400

Notes. 1. There is no interest allowed on Capitals.

2. If M. Antony's salary was to be *credited* to him instead of being *paid* throughout the year, his Current Account would have been credited with £300 and debited as he made drawings against it.

3. Interest on Drawings will be credited to a separate Interest Account, and thence transferred to Profit and Loss Appropriation Account as on the next page.

Dr. **INTEREST** Cr.

		£			£
To Profit and Loss Appropriation Account.		57	By J. Caesar—Drawings Account		42
			,, M. Antony—Drawings Account		15
		£57			£57

Illustration. A, B, and C are partners with capitals at 1st July, 1952, of £5,000, £4,000, and £1,000 respectively.

The partnership agreement provides—

(*a*) C shall be *credited* with a management salary of £500.

(*b*) After providing for (*a*), extra remuneration as provided in this paragraph (*b*), and 5 per cent interest on capital, C shall be entitled to 10 per cent of all the profits in excess of £2,000 per annum.

(*c*) B is to have one-third of the profits, after charging all provisions in (*a*), (*b*), and (*c*).

(*d*) The balance to be divided between A and C in the ratio of 4 : 1.

The profits for the year to 30th June, 1953 (*before* making ANY provision for the above) were £4,320.

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT FOR THE YEAR ENDED 30TH JUNE, 1953 Cr.

1953				£	1953			£
June 30	To Salary—C			500	June 30	By Balance	b/d	4,320
	,, Interest on Capital—							
	A	£250						
	B	200						
	C	50						
				500				
	,, Balance[1]		c/d	3,320				
				£4,320				£4,320
	To C 1/11 of £1,200 (i)			120		By Balance	b/d	3,320
	,, B 1/3 of £2,400 (ii)			800				
	,, Balance—							
	A 4/5	£1,920						
	C 1/5	480						
				2,400				
				£3,320				£3,320

[1] The balance of £3,320 is struck to make the subsequent division clear.

Computations—

(i) C obtains 1/11 of (£3,320 − £2,000) (ii) B obtains 1/4 of £3,200

B is entitled to one-third of the profits after charging his remuneration *and* his one-third, i.e. 1/4 × [£3,320 − £120 − £800].

Interest as Proportion of Profits. It will be a question of construction of the partnership agreement as to the precise significance of such an agreement, e.g. as to whether the interest is or is not to

be treated as a *charge*; if, for instance, A is to have one-fifth of the profits (as interest), whether he is to receive (or be credited with) one-fifth or one-sixth, the former being treated as an appropriation of the profits and the latter as a charge.

Agreements may vary considerably in detail; a frequent method being to allow interest on capital at a flat rate in the ordinary way, but to treat advances on a "profit" basis, the proportion of the advances to the total capital of, and advances to, the firm being the basis of the calculations, consideration being given to the date of the advance. The loan or advance will be converted, if necessary, to an annual basis, and a simple proportion calculation made, e.g. if the advance of £1,000 is made half way through the financial year it is equivalent to £500 for the year, and further supposing that the combined capitals of the firm are £3,500, then the "interest" on the advance, if deemed to be an **appropriation** of profits, will be $\frac{500}{3{,}500 + 500} = \frac{500}{4{,}000} \times$ profits, or if the interest on advance is to be deemed a **charge,** $\frac{500}{4{,}500} \times$ profits; in other words, one-eighth or one-ninth of the profits as the case may be. Again, each alternative may be based upon the profits either *before* or *after* interest on CAPITAL.

Illustration. A and B are partners sharing profits equally. Their capitals, upon which interest at 5 per cent per annum is payable, are £3,000 and £2,000 respectively. Any advance over and above capital made by a partner is to be remunerated on a profit basis, in the proportion that the advances bear to the total capital and advances.

During the year, A advanced £200 on 31st March and £1,000 on 30th September; B advanced £1,200 on 30th June.

The profits for the year ended 31st December, 19.., before charging interest on capital, were £750. The "advance" remuneration is to be taken as an appropriation of profits (AFTER charging interest on capitals). Show Profit and Loss Appropriation Account.

AVERAGE DATE OF ADVANCES

A		B
200 × 9 =	1,800	1,200 × 6 = 7,200
1,000 × 3 =	3,000	
1,200	4,800	

$\frac{4{,}800}{1{,}200} = 4$ months $\qquad \frac{7{,}200}{1{,}200} = 6$ months

The Advances are equivalent to—
A—£1,200 for 4 months = £400
B—£1,200 for 6 months = £600

$$\text{A's ratio of profits} = \frac{400}{5{,}000 + 400 + 600} = \frac{400}{6{,}000} = \frac{1}{15}$$

$$\text{B's} \;\;,, \;\;,, = \frac{600}{5{,}000 + 400 + 600} = \frac{600}{6{,}000} = \frac{1}{10}$$

In this particular illustration the calculation can be done mentally, e.g. in the case of A—

	£	
(1) £200 for 9 months . . .	150 per annum	
(2) £1,000 for 3 months . . .	250 „ „	Total £400

PROFIT AND LOSS APPROPRIATION ACCOUNT
FOR THE YEAR ENDED 31ST DECEMBER, 19..

Dr.	£	s.	d.	£	s.	d.	*Cr.*		£	s.	d.	£	s.	d.
To Interest on Capital—							By Balance .	b/d				750	0	0
A . .	150	0	0											
B . .	100	0	0											
				250	0	0								
„ Profits[1] attributable to Advances—														
A—$\frac{1}{15}$ × £500	33	6	8											
B—$\frac{1}{10}$ × £500	50	0	0											
				83	6	8								
„ Balance—														
A—$\frac{1}{2}$ . .	208	6	8											
B—$\frac{1}{2}$ . .	208	6	8											
				416	13	4								
				£750	0	0						£750	0	0

If the proportion were based upon profits AFTER charging up both interest on capital and profits on advances, the calculations would be as follows—

Let a = A's commission
b = B's commission

then $a = \frac{1}{16}(500 - b)$ and $b = \frac{1}{11}(500 - a)$

$16a = 500 - b$

$11b = 500 - a$

$\therefore \quad a = \frac{200}{7}$

$= £28$ 11s. 5d.

and $b = £42$ 17s. 1d.

Alternatively, as A and B jointly are entitled to one-sixth[2] "Advance" profits after charging them to Profit and Loss Account, the equivalent sum is *one-seventh* of £500 (divided between them in the ratio 2 : 3), viz. £71 8s. 6d.

There is no need to make a separate calculation for B, for inasmuch as he receives one-tenth of the net divisible profits as against A's one-fifteenth, he must receive half as much again as A; and if A receive £28 11s. 5d., then B must receive £28 11s. 5d. plus 50 per cent of £28 11s. 5d., i.e. £42 17s. 1d.

[1] If the proportion were based upon profits BEFORE charging Interest, the figures would be—

	£
A: $\frac{1}{15}$ × £750	50
B: $\frac{1}{10}$ × £750	75
Total	£125

Divisible profits would be £375 (i.e. £500 – £125).

[2] $\frac{1}{15} + \frac{1}{10}$

The Profit and Loss Appropriation Account will now be—

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

		£	s.	d.	£	s.	d.			£	s.	d.	£	s.	d.
To Interest on Capital—								By Balance .	b/d				750	0	0
A . .		150	0	0											
B . .		100	0	0	250	0	0								
„ Profits[1] attributable to Advances—															
A: $\frac{1}{15}$ × £428 11 6		28	11	5											
B: $\frac{1}{10}$ × £428 11 6		42	17	1	71	8	6								
„ Balance . .	c/d				428	11	6								
					£750	0	0						£750	0	0
To Balance—								By Balance .	b/d				428	11	6
A—½ . .		214	5	9											
B—½ . .		214	5	9	428	11	6								

Examination Problem. A and B were in partnership sharing profits equally after crediting interest at 5 per cent per annum on their capitals. No interest was to be charged or allowed on Current Account balances.

On 31st December, 1949, their capitals in the business were £6,000 and £3,000 respectively. On the same date B owed A £300 being the balance of an amount which B had agreed to pay A for an interest in the goodwill of the business. This debt carried no interest, and was to be discharged out of any surplus arising on B's Current Account at the end of each year, but was to be kept in the business as additional capital of A.

Balance Sheets had not been prepared regularly, and the partners had not been credited with interest or their share of profits, but investigation disclosed that A had drawn £500 per annum on account of profits and B £400 per annum, and that the surplus of assets over liabilities, as shown by the books, was as follows—

31st December,	1950	£9,250
	1951	£9,450
	1952	£9,700
	1953	£10,100

You are required to show the relative positions of the partners on 31st December, 1953. (*Institute of Chartered Accountants Inter.*)

[1] It will be observed that these figures are respectively $\frac{1}{15}$th and $\frac{1}{10}$th of the final total DIVISIBLE profits. Similar calculations would be made on £750 if the "profits" on advances were to be AFTER charging such "profits," but BEFORE charging interest on Capital.

Dr. CURRENT ACCOUNTS *Cr.*

			A			B						A			B		
			£	s.	d.	£	s.	d.				£	s.	d.	£	s.	d.
1950	To Drawings		500	0	0	400	0	0	1950	By Interest on Capital		300	0	0	150	0	0
	,, Surplus, Transferred to A's Capital Account					100	0	0		,, Profits		350	0	0	350	0	0
	,, Balance	c/d	150	0	0												
			£650	0	0	£500	0	0				£650	0	0	£500	0	0
1951	To Drawings		500	0	0	400	0	0	1951	By Balance	b/d	150	0	0			
	,, Surplus, Transferred to A's Capital Account					72	10	0		,, Interest on Capital		305	0	0	150	0	0
	,, Balance	c/d	277	10	0					,, Profits		322	10	0	322	10	0
			£777	10	0	£472	10	0				£777	10	0	£472	10	0
1952	To Drawings		500	0	0	400	0	0	1952	By Balance	b/d	277	10	0			
	,, Surplus, Transferred to A's Capital Account					95	13	9		,, Interest on Capital		308	12	6	150	0	0
	,, Balance	c/d	431	16	3					,, Profits		345	13	9	345	13	9
			£931	16	3	£495	13	9				£931	16	3	£495	13	9
1953	To Drawings		500	0	0	400	0	0	1953	By Balance	b/d	431	16	3			
	,, Surplus, Transferred to A's Capital Account					31	16	3		,, Interest on Capital		313	8	2	150	0	0
	,, Balances	c/d	663	10	4	136	9	8		,, Profits		418	5	11	418	5	11
			£1163	10	4	£568	5	11				£1163	10	4	£568	5	11
									1954	By Balances	b/d	663	10	4	136	9	8

Dr. **PROFIT AND LOSS APPROPRIATION ACCOUNTS** Cr

	1950	1951		1952		1953	
	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.	£ s. d.
To Interest on Capital—							
A . £300		305 0 0		308 12 6		313 8 2	
B . 150		150 0 0		150 0 0		150 0 0	
	450 0 0		455 0 0		458 12 6		463 8 2
" Balance—							
A . £350		322 10 0		345 13 9		418 5 11	
B . 350		322 10 0		345 13 9		418 5 11	
	700 0 0		645 0 0		691 7 6		836 11 10
	£1,150 0 0		£1,100 0 0		£1,150 0 0		£1,300 0 0

		1950	1951	1952	1953
		£ s. d.	£ s. d.	£ s. d.	£ s.
By Profit[1]	b/d	1,150 0 0	1,100 0 0	1,150 0 0	1,300
		£1,150 0 0	£1,100 0 0	£1,150 0 0	£1,300 0

Dr. **CAPITAL** Cr.

			A			B	
			£	s.	d.	£	s.
1950 Jan. 1	By Balances	b/d	6,000	0	0	3,000	0
Dec. 31	" B's Current Account . .		100	0	0		
			6,100	0	0	3,000	0
1951 Dec. 31	" B's Current Account . .		72	10	0		
			6,172	10	0	3,000	0
1952 Dec. 31	" B's Current Account . .		95	13	9		
			6,268	3	9	3,000	0
1953 Dec. 31	" B's Current Account . .		31	16	3		
1954 Jan. 1	" Balances	b/d	6,300	0	0	3,000	0

[1] Profits are computed by subtracting the opening surplus of assets over liabilities from the closing surplus, and adding the Drawings [e g profit for 1952 = £9,700 − £9 455 + £900 = £1,150]

It is necessary to compute *each* year's profit so as to ascertain what amount is available for transfer from B's Current Account to A's *Capital* Account. Obviously, as no interest is allowed on Current Accounts, no question of interest thereon arises, whilst B's capital remains unchanged, so that the only alteration in interest arises on A's increased capital.

STATEMENT OF PARTNERS' POSITIONS AS AT 31ST DECEMBER, 1953

	£
Profits—	
Closing Net Assets	10,100
Less Opening Net Assets	9,000
Increase of Net Assets	1,100
Add Drawings, £900 × 4	3,600
Total Profits	£4,700

Division	Total £	s.	d.	A £	s.	d.	B £	s.	d.
Current Accounts—									
Interest on Capital	1,800	0	0	1,200	0	0	600	0	0
Interest increase for A	[1] 27	0	8	27	0	8			
Divisible Profits	2,872	19	4	1,436	9	8	1,436	9	8
[*See below*]	[1] 4,700	0	0	2,663	10	4	2,036	9	8
Less Drawings	3,600	0	0	2,000	0	0	1,600	0	0
Increase of Net Assets	1,100	0	0	663	10	4	436	9	8
Transfer *re* Goodwill	−300	0	0				−300	0	0
	£800	0	0	£663	10	4	£136	9	8
Capital Accounts—	9,000	0	0	6,000	0	0	3,000	0	0
Transfer *re* Goodwill	[2] + 300	0	0	[2] + 300	0	0			
	£9,300	0	0	£6,300	0	0	£3,000	0	0

	£	s.	d.	£	s.	d.	£	s.	d.
Interest on Capital	1,800	0	0	1,200	0	0	600	0	0
Divisible Profits (before adjustment)	2,900	0	0	1,450	0	0	1,450	0	0
	4,700	0	0	2,650	0	0	2,050	0	0
Adjustment				+ 13	10	4	− 13	10	4
[*See above*]	£4,700	0	0	£2,663	10	4	£2,036	9	8

[1] As there is an increase of £27 0s. 8d. to A, the divisible profits are reduced by the same figure. A will suffer half of such reduced profits, hence there is a net gain to A of £13 10s. 4d., so that the above might have been shown as in the summary at the top of the next page.

[2] See footnote on next page.

SUMMARY

	Total £	s.	d.	A £	s.	d.	B £	s.	d.
Current Accounts	800	0	0	663	10	4	136	9	8
Capital Accounts	9,300	0	0	6,300	0	0	3,000	0	0
	£10,100	0	0	£6,963	10	4	£3,136	9	8

Illustration. A, B, and C are in partnership, the Head Office being in London, with branches at Bristol and Cardiff, managed by A, B, and C respectively.

B is entitled to a salary of £500 per annum and to 25 per cent the net profit of his Branch *after* charging (i) such salary and (ii) interest at 10 per cent per annum on the *average* net assets, excluding Cash, of the Branch. Similar arrangements exist for C in respect of his share of the Cardiff Branch profit.

No interest is to be charged on drawings, but allowed on Capitals at 5 per cent per annum.

The balance of profits is divisible as to one-half to A, three-tenths to B, and one-fifth to C.

The balances in the books at 31st December, 19.. are—

	Dr. £	*Cr.* £
Drawings and Capitals—		
A	2,000	10,000
B	1,700	10,000
C	1,200	8,000
Assets (except Cash) and Liabilities—		
London	14,300	2,200
Bristol	9,200	2,100
Cardiff	6,500	1,800
Cash	5,210	
Profits for year ended 31st December, 19.. (before foregoing adjustments)—		
London		3,100
Bristol		1,800
Cardiff		1,110
	£40,110	£40,110

[1] It will be seen that there are the following transfers from B's Current Account to A's Capital Account. [See page 570.]

	£	s.	d.
1950	100	0	0
1951	72	10	0
1952	95	13	9
1953	31	16	3
	£300	0	0

This will increase the interest on capital to A—

	£	s.	d.
1951—5% on £100	5	0	0
1952—5% on £172 10s.	8	12	6
1953—5% on £268 3s. 9d.	13	8	2
	£27	0	8

The net assets (as compared with the beginning of the year) have increased by £600 and £400 at Bristol and Cardiff respectively.

Prepare *Statement* to show the division of the profits of £6,010 (items above). Take to nearest £.

A, B, AND C

STATEMENT OF DIVISION OF PROFITS FOR THE YEAR ENDED 31ST DECEMBER, 19..

			A	B	C	Total
			£	£	£	£
Salaries				500	500	1,000
Interest on Capitals			500	500	400	1,400
Branches' Remuneration—	*Bristol*	*Cardiff*				
	£	£				
Profit . . .	1,800	1,110				
Less Salary .	500	500				
	1,300	610				
Less 10% on Average Net Assets	660	450				
	25% £620[1]	25% £160		155	40	195
Balance of Profits—		£				
Bristol [£1,800 − £500 − £155]		1,145				
Cardiff [£1,110 − £500 − £40] .		570				
London . .		3,100				
		4,815				
Less Interest on Capitals .		1,400				
		£3,415	(½) 1,708	(3/10) 1,024	(⅕) 683	3,415
			£2,208	£2,179	£1,623	£6,010

[1] See Note iii on page 574.

The Balance Sheet is not called for, but is given below to show completion—

BALANCE SHEET (SUMMARIZED) AT 31ST DECEMBER, 19 .

	A	B	C	£		£
Liabilities				6,100	Sundry Assets	30,000
Capitals.	£	£	£		Cash . . .	5,210
At 1st January 19	10,000	10,000	8,000			
Profits, etc. .	2,208	2,179	1,623			
	12,208	12,179	9,623			
Drawings .	2,000	1,700	1,200			
	£10,208	£10,479	£8,423	29,110		
				£35,210		£35,210

Notes. (i) As the profits are all brought into the Head Office books, the division will be made according to the amounts attributable to each partner as per statement.

(ii) No actual debit will be made to the Branch in respect of the 10 per cent interest chargeable, as this is necessary merely for the calculation of the percentage due to B and C in respect of their Branch profits. If it were, it would merely *decrease* the remaining Branch profits and increase the residue of the profits, so cancelling out each other.

(iii) The average net assets of Branches are—

	Bristol		Cardiff
	£		£
Closing [£9,200 − £2,100] . .	7,100	[£6,500 − £1,800]	4,700
Opening	6,500		4,300
	2)13,600		2)9,000
	£6,800		£4,500

The opening net assets must have been £600 and £400 respectively *less* than the closing net assets.

Adjustments Necessitated by Omission of Interest on Capital or Shares, or by Alteration of Profit Sharing Ratios in One Year, or in Several Back Years

Omission of Interest on Capital. (1) *Where Capital Accounts are Fixed.* Where by the partnership agreement partners are entitled to interest on capital and, owing to error, it has not been entered in the books, the necessary entries will be made if the discovery is "in time," that is before the Profit and Loss Account has been closed by the transfer of profit or loss to the partners' Capital or Current Accounts. Where, however, the books at the time of the discovery of the omission have been closed off, it is the practice to compute the difference between the amounts already credited in the books, and the amounts that would have been credited if the requisite transfer for interest on capital had been made, and adjust such difference by means of a Journal entry.

The partnership agreement will ordinarily determine whether the interest on capital is to be made upon the FIXED capitals, or upon the capitals as MERGED from year to year; but in either case the capital upon which the interest is to be computed is almost invariably that at the COMMENCEMENT of the period. In addition, where the profits no more than approximately cover interest on capital, the question arises as to whether interest on capital is to be CHARGED regardless of the fact that it may convert the profit (computed without charging interest on capital) into a loss.

It will readily be understood that more than one year may call for adjustment, in which case there is superimposed a possible further point, viz. that there may have been alterations in the constitution of the partnership both as to PERSONNEL and as to PROFIT PROPORTIONS.

Although the facts may create difficulties of detail, the underlying principle is an extremely elementary one. As interest on capital is a SPECIAL DIVISION of the profits of the firm (in absence of exceptional circumstances), it follows that unless the capitals of the partners are exactly in the same proportion as the profit or loss ratio, one or more of the partners has been overcredited at the

expense of another or others, so that the total amounts over-credited must equal those undercredited.

Illustration. The profits of a firm for the year are £1,000, which have been credited to A and B equally per the partnership agreement, but interest on capital, £100 for A and £20 for B, had inadvertently been ignored. Adjust.

From the above it is clear that the division of profits should have been—

Division	A	B	Total
	£	£	£
Interest on Capital . . .	100	20	120
Balance equally . . .	440	440	880
Total . . .	540	460	1,000
Division already made . .	500	500	1,000
Adjustment	+ £40	- £40	—

B has been overcredited with £40, A being similarly undercredited. A Journal entry is now required to debit B and credit A.

Alternatively, the above adjustment may be carried out in the following simple way—

(1) To treat the omitted interest as a GAIN in favour of the partners; and

(2) To treat the omitted interest as a *firm* LOSS.

Show the above in columnar form giving the adjusting figures. The preceding illustration would under this method of layout be as follows—

	Interest on Capital	"Loss"	Difference
	(1)	(2)	
	£	£	£
A . . .	100	60	+ 40
B . . .	20	60	- 40
	£120[1]	£120[1]	—

Thus the divisible profits in the "equal" ratio are diminished by such interest (which is really profit divided in the CAPITAL ratio), so that there is £120 less "equal" profits and £120 more "Capital" profits, these counterbalancing each other. The above-mentioned alternative is particularly useful where the problem does not disclose the firm's profits; for instance, the adjustment in the above example can be made by the alternative method, even if the question had not disclosed the profit of £1,000.

[1] The above statements are memoranda, the double entry being effected by a Journal entry.

Illustration. A, B, and C, partners, have omitted interest on capital for the three years ended 31st December, 1953. Their fixed capitals, upon which interest is based, were throughout:

A, £2,000; B, £1,600; C, £1,400; Interest thereon at 5 per cent per annum.

They shared profits in the following ratios respectively—

1951 : 1, 2, 2; 1952 : 5, 3, 2; 1953 : 4, 5, 1. Adjust.

As the profit-sharing ratio differs in each year, a statement will be prepared for each of the three years.

Year		Interest on Capital	Ratios	"Loss"	Difference	
		£		£	£	£
1951	A—5% on £2,000 .	100	$\frac{1}{5}$	50		+ 50
	B—5% on £1,600 .	80	$\frac{2}{5}$	100	− 20	
	C—5% on £1,400 .	70	$\frac{2}{5}$	100	− 30	
		£250		£250		
1952	A—As above . .	100	$\frac{5}{10}$	125	− 25	
	B—As above . .	80	$\frac{3}{10}$	75		+ 5
	C—As above . .	70	$\frac{2}{10}$	50		+ 20
		£250		£250		
1953	A—As above . .	100	$\frac{4}{10}$	100	—	—
	B—As above . .	80	$\frac{5}{10}$	125	− 45	
	C—As above . .	70	$\frac{1}{10}$	25		+ 45
		£250		£250		

Alternatively, the layout may be drafted thus (omitting proportion figures)—

SUMMARY

	Adjustments		Difference	
	Dr.	*Cr.*	*Dr.*	*Cr.*
	£	£	£	£
A. 1951	50	100		
1952	125	100		
1953	100	100		
	£275	£300		25
B. 1951	100	80		
1952	75	80		
1953	125	80		
	£300	£240	60	
C. 1951	100	70		
1952	50	70		
1953	25	70		
	£175	£210		35
			£60	£60

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			£	£
1953 Dec. 31	B Current Account . . . . . *Dr.*		60	
	To A Current Account			25
	" C Current Account			35
	Being transfer to adjust omission of interest on capital for the three years to date.			

In either case the statements are purely memoranda *explaining* the computation of the resultant Journal entry.

Omission of Interest on Capital. (2) *Where Capital Accounts are Merged.* Where interest on capital is to be calculated on MERGED capitals, the Capital Accounts at the beginning of each year must be ascertained, so that it is necessary to know the amount of drawings and profits or losses for *each* year in order to compute the yearly capital figure upon which interest is to be calculated.

Illustration. In addition to the facts presented in the preceding illustration, it is found that the annual drawings are £300 for A and £200 each for B and C. The profits (before interest on capital has been dealt with) are £800 for the first year and £1,000 for the second year. Interest is to be charged at 5 per cent per annum on MERGED capitals.

You are required to adjust the partners' accounts for years 1 and 2.

So far as the first year is concerned, assuming the beginning figures of capital to be "merged" at this date, the calculation for interest will not be affected because interest is computed on the capital at the commencement of the year.

In the first year the Capitals will be—

	A	B	C
	£	£	£
Balances	2,000	1,600	1,400
Add Profits (ratios 1 . 2 : 2) .	160	320	320
	2,160	1,920	1,720
Less Drawings . . .	300	200	200
	1,860	1,720	1,520
ADJUSTMENT FOR INTEREST (cf. previous illustration, page 576)	+ 50	− 20	− 30
2nd Year: Opening Balances .	£1,910	£1,700	£1,490

In the second year Interest will be based on these figures—

	Interest			Ratios	"Loss"			Difference *Dr.*			*Cr.*		
	£	*s.*	*d.*		£	*s.*	*d.*	£	*s.*	*d.*	£	*s.*	*d.*
A	95	10	0	$\frac{5}{10}$	127	10	0	32	0	0			
B	85	0	0	$\frac{3}{10}$	76	10	0				8	10	0
C	74	10	0	$\frac{2}{10}$	51	0	0				23	10	0
	£255	0	0		£255	0	0	£32	0	0	£32	0	0

In the second year the adjusting Journal entry is—

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	£	*s.*	*d.*	£	*s.*	*d.*
A Capital . . . . *Dr.*	32	0	0			
To B Capital				8	10	0
,, C Capital				23	10	0
Being adjustment in respect of interest on capital omitted in books.						

In the second year, the Capitals will be—

	A			B			C		
	£	*s.*	*d.*	£	*s.*	*d.*	£	*s.*	*d.*
Opening Balances	1,910	0	0	1,700	0	0	1,490	0	0
Add Profits (ratios 5 : 3 : 2) .	500	0	0	300	0	0	200	0	0
	2,410	0	0	2,000	0	0	1,690	0	0
Less Drawings	300	0	0	200	0	0	200	0	0
	2,110	0	0	1,800	0	0	1,490	0	0
ADJUSTMENT FOR INTEREST ON "Merged" Capital . . .	− 32	0	0	+ 8	10	0	+ 23	10	0
[1]	£2,078	0	0	£1,808	10	0	£1,513	10	0

Cancellation of Excessive Interest. The converse rule will apply where interest has been either excessively charged, e.g. 6 per cent instead of 5 per cent, or where it should not have been charged at all. The result will be a diminution of interest to the partners, and an increase of profits arising from the adjustment of the interest. The former will be charged against the partners according to their capitals, whilst the latter will be credited to them in accordance with the manner of profit sharing.

Illustration. After the accounts of a partnership have been drawn up and the books closed off, it is discovered that for the years 1952 and 1953 interest has been credited to the partners upon their capitals at 5 per cent per annum, although no provision for interest

[1] See page 579.

The accounts would have appeared thus had the interest on capital NOT been omitted—

Dr CAPITAL ACCOUNTS *Cr*

Year			A £	s	d	B £	s	d	C £	s	d
1	To Drawings		300	0	0	200	0	0	200	0	0
	,, Balances	c/d	1 910	0	0	1,700	0	0	1,490	0	0
			£2,210	0	0	£1,900	0	0	£1,690	0	0
2	To Drawings .		300	0	0	200	0	0	200	0	0
	,, Balances	c/d	2,078	0	0	1,808	10	0	1,513	10	0
			£2 378	0	0	£2,008	10	0	£1,713	10	0

Year			A £	s	d	B £	s	d	C £	s	d.
1	By Balances	b/d	2,000	0	0	1,600	0	0	1,400	0	0
	,, Profits[1]		110	0	0	220	0	0	220	0	0
	,, Interest on Capital		100	0	0	80	0	0	70	0	0
			£2,210	0	0	£1,900	0	0	£1,690	0	0
2	By Balances	b/d	1,910	0	0	1,700	0	0	1,490	0	0
	,, Profits[2]		372	10	0	223	10	0	149	0	0
	,, Interest on Capital		95	10	0	85	0	0	74	10	0
			£2,378	0	0	£2,008	10	0	£1,713	10	0
3	By Balances[3] .	b/d	2,078	0	0	1,808	10	0	1,513	10	0

[1] Profit £800, less Interest on Capital £250 = £550.
[2] Profit £1,000, less Interest on Capital £255 = £745.
[3] As shown in preceding statement

is made in the partnership agreement, and no variation by a course of dealing can be inferred.

The amounts involved are—

Partners	Interest Credited 1952	Interest Credited 1953
	£	£
A . .	350	360
B . .	200	215
C . .	110	110
	£660	£685

You are required to put through adjusting entries as on 1st January, 1954, assuming that the profits are shared in the following proportions—

	A	B	C
1952 . .	$\frac{2}{5}$	$\frac{2}{5}$	$\frac{1}{5}$
1953 . .	$\frac{3}{10}$	$\frac{4}{10}$	$\frac{3}{10}$

It may be assumed that the Capitals are "fixed." The adjusting Journal entries are—

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			£	s.	d.	£	s.	d.
1954 Jan. 1	A Current Account . . . *Dr.*		86	0	0			
	To B Current Account . . .					64	0	0
	,, C Current Account . . .					22	0	0
	Being adjustment for interest on capital improperly allowed for the year 1952 as per memorandum adjustment.							
	A Current Account . . . *Dr.*		154	10	0			
	To B Current Account . . .					59	0	0
	,, C Current Account . . .					95	10	0
	Being adjustment for interest on capital improperly allowed for the year 1953 as per memorandum adjustment.							

Memorandum ADJUSTMENT STATEMENT

	1952 Interest on Capital			1952 "Profit"			1952 Adjustment			1953 Interest on Capital			1953 "Profit"			1953 Adjustment			Combined Result		
	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.
A	350	0	0	$\frac{2}{5}$ 264	0	0	− 86	0	0	360	0	0	$\frac{3}{10}$ 205	10	0	− 154	10	0	− 240	10	0
B	200	0	0	$\frac{2}{5}$ 264	0	0	+ 64	0	0	215	0	0	$\frac{4}{10}$ 274	0	0	+ 59	0	0	+ 123	0	0
C	110	0	0	$\frac{1}{5}$ 132	0	0	+ 22	0	0	110	0	0	$\frac{3}{10}$ 205	10	0	+ 95	10	0	+ 117	10	0
	£660	0	0	£660	0	0				£685	0	0	£685	0	0						

Omission of Interest on Capital. (3) *Where Profit-sharing Ratio Varies with the Amounts of Profits.* Where the ratios of profit sharing vary with the amount of profits, it becomes necessary for

the purpose of adjusting the partners' current accounts to ascertain what profits have been earned in each year, whether Capitals are fixed or merged.

Illustration. A and B share profits as follows—

First £400 to A and the balance 2 : 1.

The profits for the year are £580; the capitals being A £2,000, and B £1,800. Interest on capital had been omitted from the books, and is to be allowed at 5 per cent per annum. Adjust.

The profits shared are—

	A	B
	£	£
First £400 .	400	
Balance 2 : 1 .	120	60
	£520	£60

The interest on capital should be—

	£
A—5% on £2,000	100
B—5% on £1,800	90

The "loss" being £190, £180 of this will be debited to A and B in the ratio of 2 : 1, i.e. scaling down the profits exceeding the first £400, and all the balance against A, thus—

"Loss"

	Total		A		B
	£		£		£
Excess of £400 (2 : 1) .	180	$\frac{2}{3}$	120	$\frac{1}{3}$	60
Balance	10		10		
	£190		£130		£60

The adjustment, therefore, is—

	Interest on Capital	"Loss"	Difference	
	£	£	£	£
A	100	130	− 30	
B	90	60		+ 30

Thus, as a result of the above the division of profits is—

	£	£
A's Share of Profits	520	
Less Adjustment	30	
		490
B's Share of Profits	60	
Add Adjustment	30	
		90
Total. .		£580

Illustration. A, B, and C are partners sharing profits in the ratio of 2 : 2 : 1. C has advanced to the firm £2,000 at 5 per cent per annum on 30th June, 19... During the year ended 31st December, 19.. (i.e. before distribution of profits), the entry relating to interest has been inadvertently made as follows—

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			£	£
19.. Dec. 31	A Current Account . . . . *Dr.*		50	
	B Current Account . . . . *Dr.*		50	
	To C Current Account			100
	Being interest at 5% per annum on C's advance.			

Assuming the books have been closed off, make the necessary corrections.

Memorandum ADJUSTMENT STATEMENT

	A	B	C
	£	£	£
The true charge which is a FIRM loss is £50 divided[1]	*Dr.* 20	*Dr.* 20	*Dr.* 10
The true credit to C is £50 . . .			*Cr.* 50
Leaving what ought to have been entered	*Dr.* 20	*Dr.* 20	*Cr.* 40
As against the above entries . . .	*Dr.* 50	*Dr.* 50	*Cr.* 100
Leaving the final adjustment of . .[2]	*Cr.* £30	*Cr.* £30	*Dr.* £60

READJUSTMENT OF PROFIT SHARING RATIOS OVER PAST YEARS

Illustration. C and D had been in partnership for three years, sharing profits and losses in proportion to their capitals, which had not changed during the period, and were £10,000 and £5,000 respectively. At the end of the third year (31st December, 1953) they agree to admit their Manager E into partnership as from the beginning of the partnership. E had been in receipt of a salary of £350 per annum during the period, and had had £3,000 on loan to the firm since its inception, upon which he had received 6 per cent per annum interest.

The Profit and Loss Accounts of the firm had shown the following results *after* charging partners' interest upon capitals at 5 per cent per annum, and E's salary and the interest upon his loan—

		£	s.	d.
1951	Profit	2,562	7	0
1952	Loss	418	15	0
1953	Profit	1,762	14	0

[1] Interest on £2,000 at 5 per cent per annum for half-year.
[2] Journalized in the usual way.

The terms upon which E was to be admitted a partner were that he should have a salary of £250 per annum and a sixth interest in the business as from 1st January, 1951, and that his loan should be treated as his capital, upon which he should receive, from the commencement of the partnership, the same rate of interest as C and D instead of the 6 per cent already paid to him, C and D's ratio as between themselves to remain unaltered.

You are required to adjust the results of each of the three years, and to show how they should be divided in accordance with the new arrangement.

Under the new arrangement the divisions are as follows—

First year, 1951—

Profit £2,562 7s. + Interest £30 and Salary £100 = Profit £2,692 7s.

	£	s.	d.
C—$\frac{10}{18}$	1,495	15	0
D—$\frac{5}{18}$	747	17	6
E—$\frac{3}{18}$	448	14	6
	£2,692	7	0

Second year, 1952—

Loss £418 15s. – Interest £30 and Salary £100 = Loss £288 15s.

	£	s.	d.
C—$\frac{10}{18}$	160	8	4
D—$\frac{5}{18}$	80	4	2
E—$\frac{3}{18}$	48	2	6
	£288	15	0

Third year, 1953—

Profit £1,762 14s. + Interest £30 and Salary £100 = Profit £1,892 14s.

	£	s.	d.
C—$\frac{10}{18}$	1,051	10	0
D—$\frac{5}{18}$	525	15	0
E—$\frac{3}{18}$	315	9	0
	£1,892	14	0

By the above arrangement E receives the following—

	£	s.	d.	£	s.	d.
1951				448	14	6
1953				315	9	0
				764	3	6
Less 1952 Loss	48	2	6			
Reduction of £130 for 3 years = £30 interest (1% on £3,000) and £100 salary . .	390	0	0			
				438	2	6
∴ Credit to E.				£326	1	0
Debit to C—$\frac{2}{3}$ of £326 1s. .				217	7	4
Debit to D—$\frac{1}{3}$ of £326 1s. .				108	13	8
				£326	1	0

Alternative Method. A much shorter method may be adopted in examinations by taking the three years together, thus—

	£	s.	d.
Profits for the three years—			
Profit, 31st Dec., 1951	2,562	7	0
Profit, 31st Dec., 1953	1,762	14	0
	4,325	1	0
Loss, 31st Dec., 1952	418	15	0
	3,906	6	0
Add Augmented Profit in respect of E—			
£130 per annum × 3	390	0	0
	£4,296	6	0
∴ E's share = $\frac{1}{6}$	716	1	0
Less Diminished Interest and Salary—			
£130 × 3	390	0	0
∴ Credit to E	£326	1	0
which must be borne by—			
Debit to C—$\frac{2}{3}$ of £326 1s	217	7	4
Debit to D—$\frac{1}{3}$ of £326 1s	108	13	8
	£326	1	0

It is assumed that (1) interest on capital is to be charged whether there are profits or losses.

(2) Interest is based upon FIXED capitals and not upon Current Accounts, otherwise the amount for each year would have to be separately computed.

Partner's Salary Adjustments. Where one of the partners is entitled to a salary and, owing to absence from duties, it is agreed that the absent partner shall forgo the whole or a portion thereof, the treatment depends upon the circumstances. The amount waived is obviously equivalent to an increase in *partnership* profits, and primarily in the absence of an agreement to the contrary enures to the benefit of the firm as a *whole*, that is, it is treated as partnership income; but the partners may agree that such waiver shall operate for the benefit *only* of the *remaining* partners; if so, it will be credited exclusively to them either in profit and loss sharing ratios, or if they themselves receive salaries, in their salary ratios. The extra salary (if any) paid for the work usually undertaken by the absent partner may be set off against the amount waived. Alternatively, if a disproportionate amount of time is spent by the partners on performing the work, they may charge up a sum corresponding therewith (which may amount to more or less than the absentee's salary), and treat the difference as a *firm* profit or loss, or as a *personal* profit or loss, either in old salary ratios or in profit and loss ratios.

Illustration. Turbie, Grasse, and Vence are partners sharing profits and losses equally, receiving salaries of £600, £400, £500 respectively. Vence agrees to waive his salary already credited to

him. The following are the methods of treatment according to agreement.

(1) Where the whole of the work is undertaken by Turbie and Grasse.

(*a*) As a FIRM profit—

			£	s.	d.
Debit Vence £500.	Credit Turbie	⅓ .	166	13	4
	Grasse	⅓ .	166	13	4
	Vence	⅓ .	166	13	4

(*b*) As a PERSONAL profit—

(i) In Salary proportions—

Debit Vence £500.	Credit Turbie	6/10 .	300	0	0
	Grasse	4/10 .	200	0	0

(ii) In Profit and Loss proportions—

Debit Vence £500.	Credit Turbie	½ .	250	0	0
	Grasse	½ .	250	0	0

(iii) On a charge basis (say)

Debit Extra Salary Account £800	Credit Turbie (say)	7/10 .	560	0	0
	Grasse (say)	3/10 .	240	0	0
Debit Vence £500 Profit and Loss Account £300[1]	Credit Extra Salary Account	.	800	0	0

(2) Where an expenditure of £100 has been incurred for extra salary paid to a temporary assistant the amount of £100 would be set off against the £500, leaving £400 to be dealt with by the above methods, e.g. (1) (*a*)—

			£	s.	d.
Debit Vence £500.	Credit Extra Salary Account	. .	100	0	0
	Turbie	⅓ .	133	6	8
	Grasse	⅓ .	133	6	8
	Vence	⅓ .	133	6	8

ADJUSTMENT OF PROFITS AND INTEREST ON CAPITAL CONSEQUENT UPON THE OMISSION OF AN ASSET FROM THE BOOKS

It sometimes happens that when a partnership is formed, one of the partners introduces an asset in the shape of a trade-mark or a patent of uncertain value. The usual basis of valuation of such an asset is a certain number of years' purchase of the average yearly sales over an agreed period. When at the end of this period the value of the asset is ascertained (no value appearing in the books in the meantime), the amount will be credited to the Capital Account of the partner who brought in the asset. If, over this period, interest on capital has been allowed, a corrective entry will be required to provide for interest on capital calculated on the value of the omitted asset.

Illustration. X and Y are partners as and from 1st January, 1951. The value of all the assets, with the exception of a patent introduced by Y, is agreed. The patent is to be valued on the expiry of

[1] Alternatively in proportions shown in (*b*) (i) and (*b*) (ii).

three years from 1st January, 1951, at 10 per cent on the sales during this period. These were—

		£
Year to 31st December, 1951	. .	6,000
1952	. .	3,500
1953	. .	500
		£10,000

The partners are to receive 5 per cent interest on their merged capitals, and are to share the balance equally. (Drawings are ignored for the sake of lucidity.)

STATEMENT OF CAPITALS (as appearing in the books)

Date	Division		X	Y
1951			£	£
Jan. 1	Capitals		3,000	2,000
Dec. 31	Interest on Capitals		150	100
	Profits		400	400
1952 Jan. 1	Balances		3,550	2,500
Dec. 31	Interest on Capitals		177	125
	Profits		360	360
1953 Jan. 1	Balances		4,087	2,985
Dec. 31	Interest on Capitals		205	149
	Profits		720	720
1954 Jan. 1	Balances		£5,012	£3,854

(Interest taken to nearest £.)

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			£	£
1953 Dec. 31	Patent . . . . . . *Dr.*		1,000	
	To Y Capital			1,000
	Being patent introduced by Y on 1st January, 1951, valued per agreement.			
	X Capital . . . . . . *Dr.*		79	
	To Y Capital			79
	Being adjustment of interest on capital relative to patent per Memorandum Adjustment Statement.			

(Interest to nearest £ to agree with Statement.)

Notes. (1) As the initial capitals are in reality equal, i.e £3,000 each, and the appropriations are equal, no drawings being taken into account, the adjusted capitals as at 1st January, 1954, should be exactly similar, viz.—

		X	Y
		£	£
Capitals at 31st December, 1953		5,012	3,854
Add Patent			1,000
,, Interest on Capital[1]			79
Less Interest on Capital		79	
Capitals at 1st January, 1954 . .		£4,933	£4,933

[1] If the original interest on capital had been computed to the nearest shilling the adjustment required would be £78 16s.

Prepare an adjusting *Statement* explaining the necessary Journal entries to give effect to the above.

Memorandum ADJUSTMENT STATEMENT (Interest to nearest 1s.)

		X Balance			X *Dr.*			X *Cr.*			Y Balance			Y *Dr.*			Y *Cr.*		
		£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.
1951 Jan. 1	Patent (10% of £10,000) . . .																1,000	0	0
Dec. 31	Interest on £1,000 at 5% per annum .																50	0	0
	"Loss" borne	− 25	0	0	25	0	0				+ 1,025	0	0	25	0	0			
1952 Dec. 31	Interest on £1,025 at 5% per annum .																51	5	0
	"Loss" borne	− 51	5	0	[1] 26	5	0				+ 1,051	5	0	25	0	0			
1953 Dec. 31	Interest on £1,051 5s. at 5% per annum .																52	11	0
	"Loss" borne	− 78	16	0	27	11	0				+ 1,078	16	0	25	0	0			

		£	s.	d.
[1] Interest on Capital £1,025 . . .	*Cr.* Y	51	5	0
Less Interest on £25 . . .	*Dr.* X	* 1	5	0
		50	0	0
Loss	*Dr.* Y £25 / *Dr.* X 25*	50	0	0
		50	0	0

* X's net debit is thus £26 5s.

(2) The profit earning capacity of the patent is clearly declining—as reflected in declining sales—hence the valuation is exaggerated. The question of depreciation also arises. As the true profit-sharing ratio has been disturbed, the allocation of income tax liability will be affected. Notes should be made on these points in examination work.

"Cash" Profits. It is usual in many professional business partnerships to take profits on the basis of RECEIPTS less PAYMENTS, that is to say, all outstandings, whether in favour or against the firm, are ignored. On the other hand, profits may be taken on a "receipts" basis, but outstandings against the firm taken into account. Both methods are unsatisfactory as full account should be taken of the following—

(1) Debtors, including prepayments.

(2) Uncompleted work.

(3) Creditors, including—

(*a*) Payments by clients in advance.
(*b*) Accrued and accruing expenses.

(4) Depreciation.

(5) Stocks. (Although stocks are likely to be fairly constant in a non-trading business, nevertheless the value of stock should be brought into the accounts.)

(6) Bad debts. (As receipts only are recorded, the accounts do not disclose the amount of bad debts.)

Where the partners decide to bring the accounts on to an "earned" basis, the items introduced into the books, whether assets or liabilities, must be credited or debited to the partners either (*a*) directly to the partners who introduced them (less depreciation borne in profit and loss ratios), or otherwise (*b*) in the profit or loss ratios. No difficulty arises where no change has occurred in the CONSTITUTION of the partnership; but the true position as at each change (if any) must be established (unless this has already been done) upon such change, whether by way of admission or retirement of a partner, or upon the alteration of ratios of profit and loss sharing.

It is of importance to distinguish carefully between the assets specifically brought in by partners, and those created during the tenure of the partnership, as the former will be credited to the partners according to their respective contributions, and the latter in profit and loss ratio.

The rules may be thus formulated—

(1) Ascertain the undisclosed assets and liabilities at the commencing date, and credit in case of assets, and debit in case of liabilities, the partners, either in profit and loss ratios or rateably to contributions, for such amounts; depreciation being charged in profit and loss ratios.

(2) Ascertain the increase or decrease in assets and liabilities treating them as ordinary partnership profits or losses; computing *each* year separately (if necessary, e.g. on changes in constitution of the firm), or treating the *whole* of the intervening years together.

(3) Prepare the above information in schedule form, analysed into columns for each partner.

(4) Debit assets ascertained by the total of (1) and (2), credit liabilities similarly obtained.

(5) Credit or debit the partners as shown in the schedule according to the result obtained by (4), i.e. if increase of assets exceeds increase of liabilities a credit will ensue to the partners; the converse will apply on a decrease of assets.

Illustration. A and B are in partnership, drawing up accounts on a cash basis. Up to 31st December, 1950, they shared profits in the ratio 3 : 2, and at that date the debtors were £100, creditors £75; from that date till 31st December, 1953, profits were shared equally.

No Interest on Capital was allowed. The debtors and creditors were:

Year ended	Debtors	Creditors	"Net" Assets Undisclosed
	£	£	£
31st December, 1951	250	90	160
" 1952	120	40	80
" 1953	300	119	181

It was agreed on 31st December, 1953, that the last three years' accounts should be computed on an "earned" basis, with proper Double Entry Accounts for debtors, etc. Ignore all other considerations.

The schedule will be constructed thus—

	Dr. (Debtors)	*Cr.* (Creditors)	A *Dr.*	A *Cr.*	B *Dr.*	B *Cr.*
	£	£	£	£	£	£
"Net" Undisclosed Assets at 31st December, 1950 . .	100	75	$\frac{3}{5}$ 45	$\frac{3}{5}$ 60	$\frac{2}{5}$ 30	$\frac{2}{5}$ 40
Increase to 31st December, 1953—						
Debtors . £300 – £100	200			$\frac{1}{2}$ 100		$\frac{1}{2}$ 100
Creditors . £119 – £75		44	$\frac{1}{2}$ 22		$\frac{1}{2}$ 22	
	300	119	67	160	52	140
Balance		181	93		88	
	£300	£300	£160	£160	£140	£140

Alternatively—

	Total	A	B
	£	£	£
Opening "Net" Undisclosed Assets .	25	3/5 15	2/5 10
Increase in "Net" Assets from 31st Dec., 1950, to 31st Dec., 1953 [£181 *less* £25].	156	½ 78	½ 78
	£181	£93	£88

The adjusting Journal entry will be—

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1953			£	£
Dec. 31	Debtors (detailed)[1] . . . . *Dr.*		300	
	To Creditors (detailed) . . .			119
	,, A Current Account . . .			93
	,, B Current Account . . .			88
	Being introduction of assets and liabilities at this date.		£300	£300

If the net assets at 31st December, 1950, of £25 represented ***original*** assets, the Journal entry (ignoring narrative) at 31st December, 1953, would be—

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1953			£	£
Dec. 31	Debtors . . . . . . *Dr.*		300	
	To Creditors.			119
	,, A Current Account . . .			78
	,, B Current Account . . .			78
	,, Capital Adjustment Account .			25

The amount of £25 would be transferred to the credit of the partners' Capital Accounts according to their original contribution, e.g. entirely to B if at the commencement of the partnership all the assets *less* liabilities were contributed by B.

Adjustment of "Cash Profits"—"Cash" Basis to "Earned" Basis. Where a firm has been carrying on business on a "cash" basis, an occasion may arise which necessitates the precise ascertainment of profits, such as requirements of income tax authorities or the dissolution of partnership. It is both inexpedient and undesirable to interfere with the partners' capital or other accounts already in the books, so that a Statement or Memorandum Account is prepared showing the excess or diminished profits ascertained on a cash basis, the differences being allocated to each partner. Where no questions arise which demand the ascertainment of true profit or loss for ***each*** year the matter is extremely simple, as all that

[1] If the practice had been to write back the debtors (*cf.* Receipts and Expenditure method), the adjustment would be to the debit of a Debtors' Reserve Account.

requires to be done is to have two columns, one for increase of profit and the other for decrease, for each year, the difference being the increased or decreased profit or loss which is then allocated in total between the partners. It is clear that any difference in profit or loss must be reflected by an increase or decrease in asset or liability, and this forms the reciprocal entry to that debited or credited to the partners' accounts.

Illustration. A and B have shared profits and losses equally, but only on a "cash" basis. It is now desired to adjust the profits and losses over the past years, and no occasion arises for obtaining each separate year's results. No interest on capital is chargeable. It has always been the practice to pay all the expenses and creditors at the end of each year, but stock, debtors, and depreciation on machinery have never been brought into the accounts.

The following are the figures for the above assets on—

	Debtors	Stock	Machinery	"Cash" Profits and Loss
	£	£	£	£
1st January, 1951	1,000	500	800	
31st December, 1951	900	750	900	+ 600
" 1952	1,300	900	900	− 100
" 1953	1,200	500	900	+ 800

Depreciation of machinery may be taken at 10 per cent (diminishing balance) each year from 1st January, 1951, to be calculated on the balances at 31st December of each current year.

Prepare Memorandum Adjustment Statement.

MEMORANDUM ADJUSTMENT STATEMENT

		Increase of "Net" Assets	Decrease of "Net" Assets
31st December, 1951—	£	£	£
Debtors	− 100		
Stock	+ 250		
Machinery[1]	+ 10		
		160	
31st December, 1952—			
Debtors	+ 400		
Stock	+ 150		
Machinery[1]	− 81		
		469	
31st December, 1953—			
Debtors	− 100		
Stock	− 400		
Machinery[1]	− 73		
			573
Balance—Increase of "Net" Assets			56
		£629	£629

[1] See p. 592.

In addition the assets, which *ex hypothesi* are not in the books at the commencement of the adjustment period, are—

	£
Debtors	1,000
Stock	500
Machinery	800
	£2,300

The figures must now be incorporated in the books, and the introduction of assets into the books will show an increase of capital, thus—

Assets at 31st December, 1953—

	£			£
Debtors	1,200			
Stock	500			
Machinery[1]	656			
	£2,356	made up of:	Additional Profit for three years	56
			Undisclosed Assets at commencement	2,300
				£2,356

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			£	£
1953 Dec. 31	Debtors	*Dr.*	1,200	
	Stock	*Dr.*	500	
	Machinery[1]	*Dr.*	656	
	To A Capital			1,150
	,, B ,,			1,150
	,, A Current Account			28
	,, B ,,			28
	Being assets and adjustments of profits introduced for the three years to date as per Memorandum Adjustment Statement.			
			£2,356	£2,356

The amount of £2,300 represents assets undisclosed at the commencement of 1951, and if it represents accumulated earnings to that date it will be divided in the partnership ratio; if, on the other hand, it represents *initial* capital, it must be credited to A and B according to their respective contributions.

[1]Machinery Account is as follows—

		£
1st Jan., 1951.	Balance	800
31st Dec., 1951.	Additions	100
		900
	Depreciation	90
31st Dec., 1952.	Balance	810
	Depreciation	81
31st Dec., 1953.	Balance	729
	Depreciation	73
	Balance	£656

The net profit for the three years on a cash basis is £600 + £800 - £100 = £1,300, already credited in the accounts, to which will be added £56, totalling £1,356, i.e. A, £678; B, £678. There is no necessity to add to or deduct from the "cash" profits or losses, but if desired (or required) the adjustment in detail will be as follows—

MEMORANDUM ADJUSTMENT STATEMENT

	Total		A		B	
	£	£	£	£	£	£
Profits for the Year ended 31st Dec., 1951	+ 600		+ 300		+ 300	
Add Increase of "Net" Assets	+ 160	+ 760	+ 80	+ 380	+ 80	+ 380
Increase of "Net" Assets to 31st Dec., 1952	+ 469		+ 235		+ 234	
Less Loss for Year ended 31st Dec., 1952	- 100	+ 369	- 50	+ 185	- 50	+ 184
Profits for the Year ended 31st Dec., 1953	+ 800		+ 400		+ 400	
Less Decrease of "Net" Assets to 31st Dec., 1953	- 573	+ 227	- 287	+ 113	- 286	+ 114
Revised profits		1,356		678		678
Less already credited		1,300		650		650
Remaining amount to be credited in respect of profits		£56		£28		£28

Where the information may be required in respect of *each* year, e.g. because (1) interest on capital is calculated on merged capitals (i.e. capital and profits less drawings), or (2) for income tax purposes, or (3) by reason of alteration in profit-sharing ratios, or (4) where profit-sharing fluctuates according to amount of profits, each year's result must be *separately* ascertained.

Illustration. Assume the same figures as in the preceding example, but that the partners share profits and losses equally to 1st January, 1951, after which the division is to be as follows—

First £300 to A
Next £200 to A and B in the ratio of 3 : 2
Next £200 to A and B in the ratio of 3 : 1
Remainder to A entirely.

You are required to adjust the positions.

The adjustment will be as shown already so far as it relates to adjusted profit or loss, but the allocation will require careful working owing to the fluctuating rates of profit.

It is therefore necessary to take each year and compute the effect of the adjustment upon the total profits, as any increase as shown in the adjustment must be allocated according to what is necessary to give effect to the partnership agreement.

(1) The first year's increase of £160. The "cash" profits have been divided as follows—

	Total	A	B
	£	£	£
First £300	300	300	—
Next £200	200	3/5 120	2/5 80
Balance (part of next £200) .	100	3/4 75	1/4 25
	£600	£495	£105

The increase of £160 is dealt with thus—

	Total	A	B
	£	£	£
Balance of £200 .	100	3/4 75	1/4 25
Remainder . .	60	60	
	£160	£135	£25

(2) The second year's increase of £469. On a "cash" basis a loss has been shown and charged to A. The increase of £469 will be dealt with thus—

	£
Increase of capital	469
Less cancellation of loss previously debited to A .	100
Balance divisible . .	£369

The increase of £469 is dealt with thus—

	Total	A	B
	£	£	£
First £300	300	300	—
Balance . . .	69	3/5 41	2/5 28
	369	341	28
Cancellation of Loss .	100	100	—
	£469	£441	£28

(3) The third year's decrease of £573. The "cash" profits of £800 have been allocated thus—

	Total	A	B
	£	£	£
1st stage . .	300	300	
2nd stage . .	200	120	80
3rd stage . .	200	150	50
4th stage . .	100	100	
	£800	£670	£130

The decrease in profits must be allocated in order that the division between the partners of true profits shall conform to the partnership agreement, hence the allocation of the decreases must be resolved by the reverse process, for after each stage of profits increase is exhausted the next stage is taken so that the decreases will first affect the final stage.

The decreases then will be dealt thus—

	Total	A	B
	£	£	£
4th stage . .	100	100	
3rd stage . .	200	150	50
2nd stage . .	200	120	80
1st stage . .	73	73	
	£573	£443	£130

It is clear from inspection that the figures within the quadrilaterals eliminate each other, thus leaving A with his original profits of £300 less decrease of £73, i.e. finally with £227; or, taken from the total figures, the true profits are £800 less £573, giving £227, all of which must belong to A, he having the exclusive right to the first £300 of profits.

Alternatively this may be shown thus—

	Total	A	B
	£	£	£
"Cash" profits . .	800	670	130
Less decrease . .	573	443	130
Revised profits . .	£227	£227	Nil

The figures for adjustment are now—

Memorandum Adjustment Statement

Year	Total		A		B	
	£	£	£	£	£	£
1951	+ 160		+ 135		+ 25	
1952	+ 469		+ 441		+ 28	
1953		− 573		− 443		− 130
Leaving revised profits .	+ £629	− £573	+ £576	− £443	+ £53	− £130
	+ £56		+ £133		− £77	

The original undisclosed assets will be dealt with as before, as they must belong to the partners as at 1st January, 1951, and assuming that they represent undisclosed profits the division of the

increase of assets at this date will be made on the old basis, £1,150 each for A and B. It will be seen that the only difference between the consequential entries in this illustration as compared with those in the preceding illustration lies in the *allocation* of the £56 item.

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			£	£
1953 Dec. 31	Debtors	*Dr.*	1,200	
	Stock	*Dr.*	500	
	Machinery	*Dr.*	656	
	To A Capital			1,150
	,, B ,, ...			1,150
	,, Capital Adjustment Account .			56
	Being assets at 1st January, 1951, entered into the books.			
	Capital Adjustment Account . .	*Dr.*	56	
	B Current Account	*Dr.*	77	
	To A Current Account			133
	Being adjustment of profits as shown by Memorandum Adjustment Statement as per agreement.			

The Capital Accounts, ignoring other assets or liabilities, and assuming that Capital and Current Accounts are to be merged, will be as follows—

CAPITAL ACCOUNTS

	£
A—£1150 + £133.	1,283
B—£1150 − £77	1,073
Total Increase (as above) . . .	£2,356

Alternative Proposals as to Profit Sharing.

Illustration. B is offered a partnership with A, and is given the following alternatives—

(1) A salary of £450 per annum plus a fifth share in profits *after* charging up his salary, or

(2) A quarter share of profits, without salary, but carrying a guarantee by A of a minimum of £400 a year.

Show which alternative is preferable.

There are several preliminary factors which must be considered before B is in a position to decide—

(1) The nature of the business, e.g. whether highly fluctuating profits.

(2) The reasonable probability of the maintenance of profits in the light of all circumstances, e.g. the business may be almost entirely "personal," and, consequently, the death or incapacity of A might cause a collapse or decline of the business.

(3) The profit curve in conjunction with capital employed.
(4) The valuation of assets including goodwill.
(5) Precise meaning of profits.
(6) The price required for goodwill.
(7) The treatment of goodwill in the books which will materially affect disposable profits, where interest on capital is to be charged.

Assuming, however, that due allowance has been made for the foregoing points, it will be seen that where the profits are on a big scale there will be no need to invoke the aid of the guaranteed minimum, but if upon a small scale the guaranteed minimum may be a valuable right, although an intending partner will naturally exercise considerable caution if the permanent profit level is so meagre that it is likely to call for the continued assistance of the guaranteed minimum. Taking an extreme case, if the profit is, say, nil, the intending partner will normally employ business sense, and avoid being a partner in a concern unable to earn profits.

Subject to the above, the advantages of one alternative over the other may be ascertained as follows—

(*a*) Where the profit level is *low*, so that the comparison is between salary plus profits as contrasted with the GUARANTEED MINIMUM, i.e.

Let P = profits, then

$$450 + \frac{P - 450}{5} = 400$$
$$2{,}250 + P - 450 = 2{,}000$$
$$\therefore P = £200$$

If profits are exactly £200, this amount will be divided as follows—

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

	£				£
To Salary	450	By Balance . . .		b/d	200
		,, A $\frac{4}{5}$ of £250 .	£200		
		,, B $\frac{1}{5}$ of £250 .	50		
					250
	£450				£450

B obtains a salary of £450 less share of loss of £50 = £400.
This exactly equals the Guaranteed Minimum.

Hence if the profits, before salary, are under £200, the guaranteed minimum is preferable.

(*b*) Where the profit level is *high*, so that the comparison is between salary plus profits as contrasted with the quarter share of profits without salary—

Let P = profits, then

$$\frac{P}{4} = 450 + \frac{P - 450}{5} \therefore P = £7{,}200$$

If profits are exactly £7,200, this amount will be divided as follows:

First alternative.

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT **Cr.**

		£			£
To Salary (B) . . .		450	By Balance . . .	b/d	7,200
,, A—⅘ of Profit £6,750 .		5,400			
,, B—⅕ of £6,750 .		1,350			
		£7,200			£7,200

B thus obtains £1,800.

Second alternative.

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT **Cr.**

		£			£
To A ¾		5,400	By Balance . . .	b/d	7,200
,, B ¼		1,800			
		£7,200			£7,200

If the profits are exactly £7,200, both methods produce the same amount of gain to B. Hence, if the profits are less than £200 or greater than £7,200, the second choice, i.e. one-quarter of profits with guaranteed minimum of £400, is preferable, because if the profits are low, B enjoys the protection of the guaranteed minimum; if high, he resorts to the quarter share of profits; if the profits fall between £200 and £7,200, the first alternative is better, i.e. "salary plus profits."

Guarantee of Profits to a Partner. Upon the admission of a new partner into a firm, the old partners may give a guarantee that he shall receive a certain minimum should the normal share to which he is entitled fall short of a stipulated amount. Such an inducement may be necessary, particularly where the new partner, in order to enter the firm, is sacrificing some other source of income, e.g. by resigning his post as a secretary to a limited company. Generally speaking, the old firm, i.e. the old partners, undertake this obligation, although in certain circumstances one only of such partners may himself assume responsibility.

The problems on this point may accordingly be divided into two sections: (1) where the guaranteed minimum is borne by *all* the remaining partners; (2) where the guaranteed minimum is borne by *one* partner only.

The "shortage" made up to the new partner is treated as a loss between the guaranteeing partners, and may be adjusted in the Profit and Loss Appropriation Account, or by means of a Journal entry to the respective Capital or Current Accounts in profit ratios. An important matter to be settled—apart from the *duration* of the guarantee—is as to whether the principle of *short workings* applies, so that in a profitable year, subsequent to that in which the benefit

of the guarantee was applicable, the guaranteed partner must re-credit the guaranteeing partners for the amount made up by them. In other words, the question at issue is whether the amount made up to the guaranteed partner should be carried forward against him, provided that he always receives his minimum, or whether each year is to be self-contained, and once the guarantee has been applied the amount paid thereunder is to be ignored in future years.

The principle applicable is similar to that of short-workings.

It is therefore extremely important that the partnership agreement shall deal clearly and unambiguously with this point, as well as that relating to the period during which the guarantee is to continue in force.

Illustration. Q and S share profits and losses in the ratio of 3 : 2, and as from 1st January, 19.. they admit O, who is to have a tenth share of the profits, with a guaranteed minimum of £1,500, Q and S continuing to share profits, as between themselves, as before. The profits of the firm in respect of the year are £10,000. Prepare Profit and Loss Appropriation Account.

Dr PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr*

		£	£			£
To Q ($\frac{27}{50}$) . .		5,400		By Balance . . .	b/d	10,000
Less Transfer to O $\frac{3}{5}$ × £500 .		300				
			5,100			
,, S ($\frac{18}{50}$) .		3,600				
Less Transfer to O $\frac{2}{5}$ × £500 .		200				
			3,400			
,, O ($\frac{5}{50}$) . .		1,000				
Add Transfer from Q .		300				
Add Transfer from S .		200				
			1,500			
		£	10,000		£	10,000

Alternatively—

Dr PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

		£			£
To Q		5,400	By Balance . . .	b/d	10,000
,, S		3,600			
,, O		1,000			
	£	10,000		£	10,000
To O—Transfer for Guaranteed Minimum .	[1]	500	By Q· $\frac{3}{5}$ × £500 .	[1]	300
			,, S. $\frac{2}{5}$ × £500 . .	[1]	200
		£500			£500

Where there are partnership salaries and interest on capital to be charged which MUST be allowed irrespective of whether there is a profit or loss, the entries, should there be either a loss or insufficient profit to provide fully for partnership salaries and interest on capital, are more involved, although the principle remains the same.

[1] Or entered through the Journal.

Junior Partners' Shares of Profit and Salaries. Junior partners' shares of profit and salaries are frequently borne personally by one of the senior partners, particularly where the senior partner in question is a relative of the junior.

There are various alternative methods of dealing with this type of problem, which are best explained by means of illustrations.

Illustration. Q and S are in partnership, sharing profits 2 : 1. Q desires to admit his son M as and from 1st January, 19... It is agreed that M shall have a twelfth share of the firm's profits, such share to be borne by his father.

The profits for the year ended 31st December, 19.., are £7,200. Show Profit and Loss Appropriation Account.

PROFIT AND LOSS APPROPRIATION ACCOUNT
Dr. FOR THE YEAR ENDED 31ST DECEMBER, 19.. *Cr.*

		£	£			£	£
To Q $\frac{2}{3}$ of £7,200 .		4,800		By Balance .	b/d		7,200
Less Transfer to M .		600					
			4,200				
,, S $\frac{1}{3}$ of £7,200 .			2,400				
,, M $\frac{1}{12}$ of £7,200 .			600				
			£7,200				£7,200

Illustration. Q and S, partners sharing profits equally, agree as from 1st January, 19.., to admit M as a partner. He is to have a tenth share of the profits, after being credited with a salary of £800. Q, in consequence of his partial retirement, agrees to bear one-quarter of the profits, and ALL the salary, of M. The profits (after charging salary) for the year to 31st December, 19.., were £8,000.

Show division of profits by means of a Profit and Loss Appropriation Account.

PROFIT AND LOSS APPROPRIATION ACCOUNT
Dr. FOR THE YEAR ENDED 31ST DECEMBER, 19.. *Cr.*

			£			£
To M—$\frac{1}{10}$ of £8,000 .			800	By Balance .	b/d	8,000
,, Balance .	c/d		7,200			
			£8,000			£8,000
To Q—$\frac{1}{2}$ of £8,200 . *			4,100	By Balance .	b/d	7,200
,, S—$\frac{1}{2}$ of £8,200 . *			4,100	,, Q— M: Salary . £800; $\frac{1}{4}$ of Profit 200		1,000
			£8,200			£8,200

* **Alternatively**

		£	£			£
To Q— $\frac{1}{2}$ of £8,200 .		*4,100*		*By Balance* .	*b/d*	*7,200*
Less M .		*1,000*				
			3,100			
,, *S— $\frac{1}{2}$ of £8,200* .			*4,100*			
			£7,200			*£7,200*

In dealing with the guaranteed minimum the length of the accounting period is important. Many instances arise in which the guaranteed partner will be entitled to a proportion only of the annual guarantee, as in the first and last years of a partnership. If, for example, A is the guaranteed partner and he enters into the firm on 1st September, and the accounting period runs to 31st December, he will, unless otherwise agreed, be entitled to the guarantee to the extent of four months, that is, if the accounting period is for one year, to four-twelfths of the annual guarantee.

Various Junior Partner's Agreements. Agreements similar to the above may take varying forms according to the particular circumstances, but the underlying principle in all cases is the same, viz., to find (1) what portion of the profits accruing to the junior partner is to be considered as a charge to the FIRM, and to see that this is properly debited before the normal shares of the other partners are ascertained; and (2) what portion of the profits accruing to the junior partner is to be considered as a *personal adjustment* between him and another partner, that is, constituting a charge to be borne *personally* by the latter.

An arrangement frequently adopted is to give to the junior partner a CHOICE between "Salary plus Profits" or "flat rate of Profit without Salary," whichever be greater, the excess of the latter over the former to be considered as a *personal debit* to one or other of the partners. The whole problem is that of finding (1) the "normal" profit and (2) the "alternative" profit, after which the amount of the difference between (2) and (1) will be adjusted against one of the partners personally. Should the "alternative" profit NOT be greater than the "normal" profit there is no amount to adjust.

Illustration. Henty senior, Wrey, and Henty junior are partners sharing profits as to Henty senior three-quarters, and as to Wrey one-quarter. Henty junior is entitled to RECEIVE a salary of £400 per annum plus 10 per cent of the profits *after* charging up *both* salary and such 10 per cent share of the profits, *or* one-fifth share of the profits, whichever is the greater; should the latter exceed the former, the excess is to be borne by Henty senior alone.

The profits for the year ended 31st December, 19.., *after* charging the salary were £4,400. Ignore interest on capital. The salary has been paid. Show accounts.

It will first be necessary to discover which is the preferable alternative so far as Henty junior is concerned.

As the profits divisible are "*after* charging salary," the latter must be added for the purpose of ascertaining the flat share due to Henty junior, thus—

	£
Profits	4,400
Plus Salary	400
Profits before Salary	£4,800

Henty Jnr.'s share = $\frac{1}{5}$ × £4,800 = £960

Under the ordinary arrangement he would be entitled to one-tenth of the profits after charging (1) salary and (2) such one-tenth share of profits, thus—

	£
Salary	400
Plus share of Profits: $\frac{1}{11} \times$ £4,400 . .	400
	£800

It follows, therefore, that the "excess" profit share for Henty junior is £160 (£960 less £800). This excess, under the partnership agreement, is to be borne PERSONALLY by Henty senior.

The division is as follows—

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr*

		£			£
To Henty Jnr.— $\frac{1}{5} \times$ £4,800 . .		960	By Balance . . .	b/d	4,400
,, Henty Senr.— $\frac{3}{4} \times$ £4,000 £3,000 *Less* Excess Profit due to Henty, Jnr. 160		2,840	,, Salary added back .		400
,, Wrey— $\frac{1}{4} \times$ £4,000 . .		1,000			
		£4,800			£4,800

Dr. HENTY JNR. CURRENT ACCOUNT *Cr.*

		£			£
To Salary added back .		400	By Profit and Loss Appropriation Account .		960
,, Balance . . .	c/d	560			
		£960			£960
			By Balance . . .	b/d	560

Henty, Junr., will thus obtain from the firm £560 PLUS the salary £400 already PAID to him.

The Profit and Loss Appropriation Account may alternatively be drawn up thus—

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

		£			£
To Henty Jnr.— $\frac{1}{11} \times$ £4,400 . .		400	By Balance . . .	b/d	4,400
,, Balance . . .	c/d	4,000			
		£4,400			£4,400
To Henty Jnr.— Further Share of Profits		160	By Balance . . .	b/d	4,000
,, Henty Senr.— $\frac{3}{4} \times$ £4,000 £3,000 *Less* Share above due to Henty Jnr. 160		2,840			
,, Wrey— $\frac{1}{4} \times$ £4,000 . .		1,000			
		£4,000			£4,000

With the necessary changes, the same principle is applied if a loss ensues.

Another alternative is the "hotchpot" method thus—

(1) Profit divisible as if no special arrangement existed.
(2) Add amount to be charged personally to partner(s).
(3) Divide the total of 1 and 2 in profit ratios.
(4) Deduct (2) from the share of partner(s) to be charged.

Illustration. Working of previous illustration

	Total		Henty, senr.		Wrey
	£		£		£
(1) Profit	3,840				
(2) "Charge" . . .	160				
(3) Division . . .	4,000	$\frac{3}{4}$	3,000	$\frac{1}{4}$	1,000
(4) Deduction . . .	160		160		—
	£3,840		£2,840		£1,000

Illustration. X and Y share profits in the following way—

(*a*) Salaries £500 and £250 respectively. (*b*) Balance equally.

X, wishing to take a less active part in the affairs of the firm, agrees with Y that the latter shall in future receive £500 and X £250, the ratio of interest in the firm remaining as before, subject to Z being introduced as a partner at a salary of £750 and one-seventh share in the profits and losses of the firm (after charging interest on capital and all salaries), all of which was to be charged to X with the exception of £500, the amount of salary Z had formerly received as manager. X and Y each had £5,000 capital in the firm, upon which they were entitled to 5 per cent interest, and Z was admitted a partner without capital on 1st January, 19... The profit for the year ended 31st December, 19.., BEFORE charging interest on capital or partners' salaries, was £1,370.

Prepare Profit and Loss Appropriation Account of the firm.

PROFIT AND LOSS APPROPRIATION ACCOUNT
FOR THE YEAR ENDED 31ST DECEMBER, 19..

Dr. *Cr.*

			£			£	£
To Interest on Capital	[1]		500	By Balance . .	b/d		1,370
" Salaries	[1]		1,250	" Loss for the purpose of computing Y's Share .	c/d		380
			£1,750				£1,750
To Balance . .	b/d		380	By Loss for the purpose of computing Z's Share . .	c/d		630
" Salary Z (£750 − £500) . .			250				
			£630				£630
To Balance . .	b/d		630	By Y: $\frac{1}{2}$ × £380 .			190
				" Z: $\frac{1}{7}$ × £630 .			90
				" X: $\frac{1}{2}$ × £380 .		190	
				[2] *Add* Z's extra Share of Profits .		160	
							350
			£630				£630

[1] Per question. [2] £250 less £90 (see page 604).

The above adjustments may be entered through the Journal and posted therefrom to the current accounts of the partners.

Alternatively, this may be worked as follows—

PROFIT AND LOSS APPROPRIATION ACCOUNT
Dr. FOR THE YEAR ENDED 31ST DECEMBER, 19.. *Cr.*

			£			£	£
To Balance (*as above*) .	b/d		380	By Y: ½ × £380 .			190
,, Z's extra Share of Profits borne by X (as below) .			160	,, X: ½ × £380 .		190	
				Add Z's extra Share of Profits . .		160	
							350
			£540				£540

Computation of Z's extra share —

	£	£
Salary		250
Loss after charging—		
Interest on Capital and Normal Salaries	380	
Z's Extra salary . . .	250	
Total Loss . .	£630	
Less $\frac{1}{7}$ thereof . . .		90
Extra share due to Z		£160

Recoupment of Minimum in Subsequent Years. It has been seen that if the profits are insufficient to give the guaranteed partner his normal share of profits, the shortage is made up by the guaranteeing partners. If it is agreed that the amount necessary to give the guaranteed partner his minimum shall be recoupable in succeeding years, such carry forward may be shown as a Suspense Account rather than as a debit against the guaranteeing partners' Capital Accounts; and in the subsequent years surplus profits will be credited back thereto. When the recoupment takes place, the guaranteed partner's account will be debited and the Suspense Account credited. Summarized, the entries are—

(A) (1) For the "shortage" year—
Debit Capital or Current Accounts of guaranteeing partners in profit and loss ratios.
Credit Capital or Current Account of guaranteed partner.
(2) In the year of recoupment the entries will be the reverse of (1).

or

(B) (1) Debit Suspense Account.
Credit Capital or Current Account of guaranteed partner.
(2) Reverse of (1).

If the opportunity to recoup has gone by, owing to effluxion of time or from any other cause, the balance in (B) on Suspense Account must be debited to the Capital or Current Accounts of

the guaranteeing partners in their profit and loss ratios; and if such ratios have changed during the period in which the guarantee is operative, the amount of shortage must be debited in the proportions applicable to the years in which the constituent shortages making up the balance *arose*.

It will be seen that the latter method may be extremely troublesome should profit-sharing ratios change during such a period, and consequently in such cases method (A) is preferable.

Where a LOSS is incurred, the guaranteeing partners, in addition to bearing their normal share of loss, incur a further liability by paying the guaranteed minimum, so that the two figures, i.e. loss and guaranteed minimum, must be added together in dealing with the problem involved.

Illustration. A and B share profits in the ratio of 3 : 1. C is admitted on the basis of one-fifth of the profits, the balance between the old partners remaining in the old ratio. Under the partnership agreement C is to have a guaranteed minimum for *four* years to the extent of £500, A and B to have the right of recoupment out of C's share of profits for *five* years only, that is, any balance to be available for recoupment until, but no longer than, the end of the year subsequent to the expiry of the "guarantee" period.

The results were—

	£		£
Year 1 Profit . .	1,800	Year 4—**Loss** . .	**400**
Year 2 Profit . .	2,100	Year 5—Profit . .	4,000
Year 3 Profit . .	3,000		

The effect of the above may be best shown in statement form, the double entry being elementary once the figures are ascertained.

	Profit		A	B	C	Recoupable	
		Ratios =	3	1	1		
	£		£	£	£	£	£
Year 1 .	1,800		1,080	360	360		
		Guarantee	− 105	− 35	+ 140	140	
Total .	£1,800		£975	£325	£500		
Year 2 .	2,100		1,260	420	420		
		Guarantee	− 60	− 20	+ 80	80	
Total .	£2,100		£1,200	£400	£500		
Year 3 .	3,000	Guarantee	1,800	600	600		
		Recoupment	+ 75	+ 25	− 100		100
Total .	£3,000		£1,875	£625	£500		
Year 4 .	− 400		− 240	− 80	− 80		
		Guarantee	− 435	− 145	+ 580	580	
Total .	−£400		−£675	− £225	+£500	£800	£100
						Balance—£700 (See year 5)	

In Year 5 the guarantee ceases and the sum of £700 is recoupable from C, but only out of his *profits*; that is, if his share of profits

is less than £700, only such share of profits is available for appropriation against the carry forward, the balance being a loss against A and B in the ratio of 3 : 1.

	Profit		A	B	C
		Ratios . .	3	1	1
	£		£	£	£
Year 5 .	4,000	Guarantee . .	2,400	800	800
		Recoupment . .	+ 525	+ 175	− 700
Total .	£4,000		£2,925	£975	£100

In the above illustration the guarantee has been dealt with each year against the partners' Capital Accounts, and the end column inserted as a note to show the amount capable of being recouped.

As there is a sufficiency of profits in favour of C to enable A and B to recoup their guarantee payments, the total of the profits to each partner will be precisely the same as if no guarantee had existed.

If the Suspense method had been used, the partners' and Suspense Accounts would be (eliminating details)—

	Suspense Account		A		B		C	
	Dr.	*Cr.*	*Dr.*	*Cr.*	*Dr.*	*Cr.*	*Dr.*	*Cr.*
	£	£	£	£	£	£	£	£
Year 1 .	140[1]			1,080		360		360 140[1]
,, 2 .	80[1]			1,260		420		420 80[1]
,, 3 .		100[1]		1,800		600	100[1]	600
,, 4 .	580[1]		240		80		80	580[1]
,, 5 .		700[1]		2,400		800	700[1]	800
	£800	£800	240	6,540	80	2,180	880	2,980
	(as on page 605)		6,300		2,100		2,100	
			£6,540	£6,540	£2,180	£2,180	£2,980	£2,980

If the profits for Year 5 had been, say, £2,000, C's share thereof would be £400 only; hence of £700 unrecouped, £400 only would be available, and A and B would be involved in a final loss on guarantee to the extent of £300, divided as to £225 and £75 to A and B respectively, being their ratio (as between themselves) of losses.

If interest on merged Capital and Current Accounts is to be credited to partners, or where profit and loss ratios are constantly changing, the first method is preferable.

It is impossible entirely to cover the infinite range of problems that arise on (1) guaranteed shares of profits, (2) guaranteed profits from the particular portion of the business brought in by one partner, and (3) shares of profits and losses and salaries paid to junior partners which are borne entirely by one of the senior partners.

[1] These items show the creation and elimination of the Suspense Account.

Further illustrations are given below and on page 610, not so much with a view to exhaust the whole scope of different variations that are encountered, but rather to provide a firm basis of principle which will serve to establish a technique for the solution of all problems of this nature.

Illustration. A, B, and C, each carrying on business as accountants, decided to amalgamate; the sharing of profits and losses to be 4, 3, and 1, provided—

(*a*) That C is to have a guaranteed minimum of £400.

(*b*) That the gross fees earned by B on the average of the last three years are to be guaranteed *to* the firm by B.

The profits of the first year of the new partnership were £2,400 before any adjustments had been made.

The gross fees earned by B in the three years prior to the amalgamation were—

Year 1, £1,200. Year 2, £1,300. Year 3, £1,100.

The gross fees attributable to B's connection in the first year of the partnership were £800.

Show Profit and Loss Appropriation and Current Accounts.

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

		£			£
To Capital Accounts—			By Balance	b/d	2,400
A: $\frac{4}{8}$		1,400	,, Fees guaranteed by B [£1,200 − £800]		400
B: $\frac{3}{8}$		1,050			
C: $\frac{1}{8}$		350			
		£2,800			£2,800

Dr. CURRENT ACCOUNTS *Cr.*

		A	B	C			A	B	C
		£	£	£			£	£	£
To *C for Guaranteed Minimum [to nearest £]*		$\frac{4}{7}$ 29	$\frac{3}{7}$ 21		By Profit and Loss Appropriation Account		1,400	1,050	350
,, Profit and Loss Appropriation Account Fees Guaranteed			400		,, *A and B for Guaranteed Minimum per contra*				60
,, Balances	c/d	1,371	629	400					
		£1,400	£1,050	£400			£1,400	£1,050	£400
					By Balances	b/d	1,371	629	400

TYPICAL EXAMINATION PROBLEMS

Appended are a few typical examination problems which are based upon the principles already formulated.

Illustration. A and B formed a partnership on 1st January, 19.., as professional coaches, sharing profits in proportion to the time spent as follows—

(1) On constructive work in preparation of courses at 7s 6d. an hour.

(2) On tuition work at 10s. an hour.

And (3) Balance equally.

You are supplied with the following information—

	£
The Fees earned during the year were	1,620
Expenses	300
Cost of Courses, including Partners' time	250
Fees Paid in Advance	120
Estimated Value of Courses	50
Capitals: A	200
B	100
Current Accounts, after being credited with Constructive Fee and debited with Drawings: A	510
B	380
Cash in Bank	300
Fixtures	100
Debtors	200

The time spent was—

On Constructive work. A—240 hours. B—160 hours.
On Tuition work. A—600 hours. B—1,200 hours.
Interest on Drawings at 5% per annum to be charged to the partners (assume at a mean date of 30th June, 19..).

Prepare Trial Balance, Profit and Loss Account, and Balance Sheet as at 31st December, 19...

TRIAL BALANCE, 31ST DECEMBER, 19..

	Dr.	Cr.
	£	£
Fees		1,620
Expenses	300	
Cost of Courses	250	
Fees Paid in Advance		120
Capitals: A		200
B		100
Current Accounts: A	510	
B	380	
Cash in Bank	300	
Fixtures	100	
Debtors	200	
	£2,040	£2,040

Note. (*a*) The item "Fees paid in advance" is a credit balance and must be included in the Trial Balance, the Fees Account being EARNED fees, so that the adjustment in the books has been made—if the abridged double entry is employed—by debiting Fees Account and bringing down below the line: if the full Ledger and subsidiary books are used, the amounts received will have been posted direct to the credit of clients' accounts in the ordinary way, and will thus appear as creditors.

(*b*) The Value of Courses at the end must be excluded from the Trial Balance, being equivalent to "Stock on hand." The phrase "Cost of Courses" is ambiguous, and might be the adjusted cost AFTER the end value has been credited thereto, but as the Trial Balance agrees without the inclusion of the item, the inference must be drawn that Value of Courses figure is not a balance.

PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 31ST DECEMBER, 19..

Dr.	£	£	Cr.	£	£
To Construction of Courses		200	By Fees		1,620
,, Expenses		300	,, Interest on Drawings—		
,, Tuition		900	A (see Note 1)	15	
,, Net Divisible Profit—			B (see Note 1)	11	
A: ½ Share	123				26
B: ½ Share	123				
		246			
		£1,646			£1,646

CURRENT ACCOUNTS

Dr.		A	B	Cr.		A	B
		£	£			£	£
To Balances (see below)	b/d	510	380	By Tuition Salary		300	600
,, Interest on Drawings		15	11	,, Profit and Loss Account		123	123
,, Balance	c/d		332	,, Balance	c/d	102	
		£525	£723			£525	£723
To Balance	b/d	102		By Balance	b/d		332

BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£	£		£
Clients for Fees in Advance		120	Cash in Bank	300
Capital—			Debtors	200
A	£200		Courses at Valuation	50
B	100		Fixtures	100
		300	Current Account—A	102
Current Account—B		332		
		£752		£752

Note 1. As the time charges for the preparation of the courses have already been credited to the Current Accounts, the Drawings must be the sum of the debit balances appearing in the Trial Balance and the amounts of the charges for preparation of the courses. The latter are A, 240 hours at 7s. 6d. an hour = £90, and B, 160 hours at 7s. 6d. an hour = £60. The Drawings, therefore, must be A, £600 (£510 plus £90), and B, £440 (£380 plus £60). Interest for *half-year* on £600 at 5 per cent per annum is £15, that on £440 is £11, as shown in the Profit and Loss Account. The Current Accounts would appear thus (*before* extraction of Trial Balance)—

CURRENT ACCOUNTS

Dr.		A	B	Cr.		A	B
		£	£			£	£
To Drawings		600	440	By Course Preparation		90	60
				,, Balances	c/d	510	380
		£600	£440			£600	£440
To Balances [per Trial Balance]	b/d	510	380				

Note 2. Although fees paid in advance by students are usually not returnable, in the absence of data to that effect or as to what amount included in the £120 represents payments by students who have abandoned the course, the proportion to be treated as profit cannot be estimated.

Note 3. If provision is made for "Guarantee till Successful" or other forms of guarantee, a proportion of fees would be carried forward to Guarantee Account by the usual entry, e.g. if £200 is considered reasonable the Fees Account would be closed thus—

Dr. FEES *Cr.*

			£				£
	To Profit and Loss Account		1,420		By Balance . . .	b/d	1,620
	,, Guarantee Suspense .		200				
			£1,620				£1,620

Dr. GUARANTEE SUSPENSE *Cr.*

							£
					By Fees Account . .		200

Alternatively—

Dr. FEES *Cr.*

			£				£
	To Profit and Loss Account		1,420		By Balance . . .	b/d	1,620
	,, Guarantee Provision .	c/d	200				
			£1,620				£1,620
					By Balance . . .	b/d	200

As will be obvious to students, both methods have the same effect, and £200 will be shown in the Balance Sheet as a liability.

Note 4. For the purpose of income tax the charge made by the partners is analogous to partners' salaries, and would be added to the profits accordingly.

Illustration. A and B are equal partners. On 31st March, 1952, the following balances stood to the credit of the partners—

A—Capital Account .	£30,000	B—Capital Account .	£12,600
A—Current Account .	£2,080	B—Current Account .	£860

The partners agree that A junior (A's son) shall be admitted into the firm as and from 1st April, 1952, it being provided that—

(*a*) Partnership salaries to be CREDITED: B £750 and A junior £600.

(*b*) A junior to have a tenth share of the profits, such share being borne by A.

(*c*) Interest on Capital and Current Accounts at 5 per cent per annum.

(*d*) Interest to be charged on drawings of A and B.

On 1st April, 1952, B transferred his rights in a patent to the firm, and it was agreed that £3,000 should be credited to his Capital Account therefor.

On 1st October, 1952, A paid £5,000 into the firm by way of additional capital.

The partners' drawings were: A £2,600 (interest £65), B £1,800 (interest £40), A junior £500.

In addition to the accounts necessary to give effect to the above, the following balances were extracted from the books of the firm as on 31st March, 1953.

	£
Factory	20,566
Sundry Creditors	4,081
General Expenses	14,737
Stock, 31st March, 1953	10,224
Provision for Bad Debts, 31st March, 1952	400
Sundry Debtors	12,860
Furniture, Plant, and Machinery,	21,506
Cash in Bank	4,048
Shares in "X," Ltd. (2,000 of £1 each fully paid)	2,000
Gross Profit	35,820

After making the adjustments as required below, prepare Profit and Loss Account for the year ended, and Balance Sheet as at, 31st March, 1953.

(*a*) The furniture, plant, and machinery were revalued at £17,388; shares at £1,500.

(*b*) Expenses outstanding at 31st March, 1953, £226; prepayments £658.

(*c*) Provision for Bad Debts to be increased to £700.

The second portion of the account on page 612 is the appropriation section of the Profit and Loss Account, as every item contained therein is an "internal" matter and, as such, affects not the dimension of the profits, but their allocation as between the partners. Unless otherwise stated, profits should always be split before any "internal" adjustments, e.g. Interest on Capital, are made, the latter being as clearly appropriation items as those comprising the formal division of profits.

TRIAL BALANCE AS AT 31ST MARCH, 1953

	Dr.	Cr.
	£	£
Capitals—		
A		35,000
B		15,600
Current Accounts—		
A		2,080
B		860
Drawings—		
A	2,600	
B	1,800	
A Jnr.	500	
Sundry Creditors.		4,081
Factory	20,566	
Patent	3,000	
Furniture, Plant, and Machinery	21,506	
Stock.	10,224	
Shares in "X," Ltd.	2,000	
Sundry Debtors	12,860	
Bad Debts Provision		400
Bank	4,048	
Gross Profit		35,820
General Expenses	14,737	
	£93,841	£93,841

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST MARCH, 1953

Dr.							*Cr.*
		£	£			£	£
To General Expenses			14,305	By Gross Profit	b/d		35,820
,, Depreciation			4,118				
,, Bad Debts			300				
,, Loss on Investments			500				
,, Balance	c/d		16,597				
		£	35,820			£	35,820
To Salaries—				By Balance	b/d		16,597
A Jnr.		600		,, Interest on Drawings—			
B		750	1,350	A		65	
,, Interest on Capitals—				B		40	105
A [1]		1,625					
B [1]		780	2,405				
,, Interest on Current Accounts—							
A		104					
B		43	147				
,, Balance: Profit divided—							
A ½ × £12,800 £6,400 *Less* A Jnr. 1,280		5,120					
B ½ × £12,800		6,400					
A Jnr. 1/10 × £12,800		1,280	12,800				
		£	16,702			£	16,702

[The Balance Sheet is shown on page 613.]

Receipts and Expenditure Accounts. Reference has already been made to this method of drawing up accounts, so that no difficulty should be encountered in the case of professional partnerships.

Illustration. A and B share profits in the ratio of 3 : 2, on the basis of fees received. The first year's Trial Balance dated 30th September, 19.. is as follows—

TRIAL BALANCE

	Dr.	*Cr.*
	£	£
Capitals (after adjustment of Drawings)—		
A		400
B		340
General Expenses	300	
Furniture and Equipment	250	
Bank	920	
Debtors	230	
Fees Account (per Bills Delivered Book)		960
	£1,700	£1,700

[1] Interest on Capitals—

	£	£
A: £30,000 at 5% per annum for one year	1,500	
£5000 at 5% per annum for six months	125	
		1,625
B: £15,600 at 5% per annum for one year		780

Balance Sheet as at 31st March, 1953

	£	£
Current Liabilities—		
Sundry Creditors	4,081	
Expenses Accrued	226	
		4,307
Capitals—		
A: Balance, 1st April, 1952	30,000	
Add Cash brought in	5,000	
		35,000
B: Balance, 1st April, 1952	12,600	
Add Patent introduced	3,000	
		15,600

Current Accounts

	A £	A £	B £	B £	A Jr. £
Balances, 1st Apl., 1952		2,080		860	
Add Interest on Capital		1,625		780	
„ Interest on Current Account		104		43	
„ Profits		5,120		6,400	1,280
„ Salary				750	600
		8,929		8,833	1,880
Less Drawings	2,600		1,800		500
„ Interest thereon	65		40		
		2,665		1,840	
		£6,264		£6,993	£1,380

	£
Current Accounts	14,637
	£69,544

		£	£
Fixed Assets—			
Patent			3,000
Factory			20,566
Furniture, Plant, and Machinery		21,506	
Less Depreciation		4,118	
			17,388
Investment—			
Shares in "X," Ltd.		2,000	
Less Provision for Loss in Value		500	
			1,500
Current Assets—			
Stock		10,224	
Sundry Debtors	£12,860		
Less Bad Debts Provision	700		
	12,160		
Add Prepayments	658		
		12,818	
Cash at Bank		4,048	
			27,090
			£69,544

Show Profit and Loss Account and Balance Sheet.

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 30TH SEPTEMBER, 19..

Dr.	£	£	*Cr.*	£	£
To General Expenses .		300	By Fees . . .		730[1]
„ Profit to Capital Accounts—					
A $\frac{3}{5}$ . .	258				
B $\frac{2}{5}$ . .	172				
		430			
		£730			£730

[1] This account may be shown thus—

FEES

Dr.	£	*Cr.*	£
To Debtors Reserve .	230	By Sundries	960
„ Profit and Loss Account	730		
	£960		£960

To save time in examination work, the details may be inserted in the Profit and Loss Account itself as an inset column, e g.—

Fees £960, *less* Debtors Reserve £230, equals £730.

BALANCE SHEET AS AT 30TH SEPTEMBER, 19..

	£	£		£	£
Capital Accounts—			Bank		920
A: Balance	400		Debtors	230	
Plus Profit	258		*Less* Debtors Reserve . .	230	*nil*
		658			
B: Balance	340		Furniture and Equipment .		250
Plus Profit	172				
		512			
		£1,170			£1,170

Preparation of Partnership Accounts by Single Entry. If accounts are prepared on the single entry system, the methods already explained apply, except that separate capital and current accounts will be kept.

Illustration. A and B are partners keeping their books on the single entry system.

The assets, less liabilities at 1st January, 19.., were £8,000.

The assets, less liabilities at 30th June, 19.., were £6,800.

Drawings, A £1,000, B £820.

B has used £100 firm goods for private purposes.

The charge for interest on capital is A £125, B £75, being at the rate of 5 per cent per annum.

They share profits equally. No interest is charged on drawings.

Provide £300 depreciation. Show Statement of Profits and Statement of Affairs at 30th June, 19...

STATEMENT OF PROFITS FOR THE HALF-YEAR ENDED 30TH JUNE, 19..

Dr.		£	£				£	*Cr.* £
To Commencing Capitals—				By Closing Capitals . .				6,800
A . . .		5,000		,, Drawings—				
B . . .		3,000		A: Cash . . .			1,000	
			8,000	B: Cash .	£820			
,, Depreciation . .			300	Goods .	100		920	
,, Balance . . .	c/d		420					1,920
			£8,720					£8,720
To Interest on Capitals—				By Balance . . .		b/d		420
A		125						
B		75						
			200					
,, Net Profit—								
A ½ . . .		110						
B ½ . . .		110						
			220					
			£420					£420

STATEMENT OF AFFAIRS, AS AT 30TH JUNE, 19.

	£	£			£	£	£
Capital Accounts—			Sundry Assets (less Liabilities) . . .			6,800	
A	5,000		*Less* Depreciation .			300	
B	3,000	8,000					6,500
			Current Accounts—				
			A: Drawings . .		1,000		
			Less Profit .	£110			
			,, Interest on Capital .	125			
					235	765	
			B: Drawings . .		920		
			Less Profit .	£110			
			,, Interest on Capital .	75			
					185	735	1,500
		£8,000					£8,000

Note. Detailed assets and liabilities eliminated. Interest for *half-year* is 2½ per cent. ∴ The capitals are: A $\frac{100}{2\frac{1}{2}} \times £125 = £5,000$; B $\frac{100}{2\frac{1}{2}} \times £75 = £3,000$.

Illustration. Denholme and Wilsden were partners sharing profits 3 : 1, there being no interest on Capital, partnership salaries, etc. On 1st January, 19.., Cullingworth was admitted a partner. Goodwill was valued at £4,800, not to be brought into the books. The new basis of profit sharing was Denholme one-quarter, Wilsden one-half, Cullingworth one-quarter. No interest on Capital nor salaries are to be charged, except that Wilsden is to receive £200 per annum as from 1st April, 19...

Wilsden and Cullingworth paid Denholme their share of goodwill, the money being left in the business as additional capital of Denholme at 4 per cent per annum as from 1st January, 19... Cullingworth paid in cash capital of £3,000.

The last Balance Sheet of the old firm as at 30th June prior to the change was—

BALANCE SHEET AT 30TH JUNE, 19..

	£	£		£
Creditors		4,171	Fixtures, etc.	2,160
Accruals		187	Motor Vehicles	1,750
Capitals—			Debtors	6,230
Denholme	8,359		Stock	4,167
Wilsden	4,713		Bank	3,123
		13,072		
		£17,430		£17,430

The following information is disclosed by the books—

	To 31st Dec.	To 30th June
	£	£
Cash received from Debtors	7,432	8,622
Cash paid: Expenses	1,848	2,290
Creditors	3,269	7,567
Drawings: Denholme	520	330
Wilsden	400	700
Cullingworth	—	360
Sales	8,310	10,800
Purchases	4,230	8,180
Bad Debts	270	*nil*

Expenses outstanding at 31st December and 30th June were £173 and £123 respectively. Stock at 30th June, 19.., was £3,200. No Stock was taken at 31st December, but it was agreed that it should be estimated at a figure consistent with the total rate of gross profit earned for the whole year. Depreciation is to be provided on the Motor Vehicles at 20 per cent per annum.

Prepare Trading and Profit and Loss Account for the year ended 30th June, 19.. and Balance Sheet at that date. Ignore tax.

TRADING AND PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 30TH JUNE, 19..

	To 31st Dec.	To 30th June	Total		To 31st Dec.	To 30th June	Total
	£	£	£		£	£	£
To Stock	4,167	2,580	4,167	By Sales	8,310	10,800	19,110
„ Purchases	4,230	8,180	12,410	„ Stock	2,580	3,200	3,200
„ Gross Profit c/d	2,493[1]	3,240	5,733				
	£10,890	£14,000	£22,310		£10,890	£14,000	£22,310
To Expenses[2]	1,834	2,240	4,074	By Gross Profit b/d	2,493	3,240	5,7[illegible]
„ Bad Debts	270	—	270				
„ Depreciation	175	175	350				
„ Balance c/d	214	825	1,039				
	£2,493	£3,240	£5,733		£2,493	£3,240	£5,733
To Salary	—	50	50	By Balance b/d	214	825	1,039
„ Interest on Capital	—	48[3]	48				
Profit—							
Denholme	161	182	343				
Wilsden	53	363	416				
Cullingworth	—	182	182				
	£214	£825	£1,039		£214	£825	£1,0[illegible]

For Notes [1], [2] and [3] see page 617

Balance Sheet as at 30th June, 19..

	D	W	C	£
Creditors—			£	
Goods			5,745[4]	
Expenses			123	
				5,868
Capitals—	D £	W £	C £	
Balance, 1st July, 19 .	8,359	4,713		
Cash introduced			3,000	
Goodwill	2,400[5]			
Interest on Capital	48			
Salary		50		
Profit	343	416	182	
	11,150	5,179	3,182	
Drawings	850	1,100	360	
	£10,300	£4,079	£2,822	17,201
				£23,069

	£	£
Fixtures, etc		2,160
Motor Vehicles	1,750	
Less Depreciation	350	
		1,400
Stock		3,200
Debtors		9,016[7]
Bank		7,293[8]
		£23,069

Notes:

(1) $\frac{8,310}{19,110} \times £5,733 = £2,493$ $\quad\therefore$ Stock at 31st December automatically £2,580.

(2) **Expenses**

	£		£
To Cash	1,848	By Balance b/d	187
,, Balance c/d	173	,, Profit and Loss Account	1,834
	£2,021		£2,021
To Cash	2,290	By Balance b/d	173
,, Balance c/d	123	,, Profit and Loss Account	2,240
	£2,413		£2,413
		By Balance b/d	123

(3) 4 per cent p.a. for 6 mos. on £2,400 (see Note 5 below).

(4) **Creditors**

	£		£
To Cash (1)	3,269	By Balance b/d	4,171
,, Cash (2)	7,567	,, Purchases (1)	4,230
,, Balance c/d.	5,745	,, Purchases (2)	8,180
	£16,581		£16,581
		By Balance b/d	5,745

(5) **Goodwill**

	D	W	C
Old Shares	$\frac{3}{4}$	$\frac{1}{4}$	—
New Shares	$\frac{1}{4}$	$\frac{1}{2}$	$\frac{1}{4}$
	Sells $\frac{1}{2}$	Buys $\frac{1}{4}$	Buys $\frac{1}{4}$ of £4,800

$\therefore$ *Cr.* £2,400 *Dr.* £1,200 *Dr.* £1,200

[For explanation of method used in adjustment of goodwill, see pages 627 (2*b*) and 629.]

Notes:—(contd.)

(6) BANK

	£		£
To Balance b/d	3,123	By Expenses (1)	1,848
" Debtors (1)	7,432	" Expenses (2)	2,290
" Debtors (2)	8,622	" Creditors (1)	3,269
" Goodwill	2,400	" Creditors (2)	7,567
" Cullingworth	3,000	" Drawings (1)	920
		" Drawings (2)	1,390
		" Balance c/d	7,293
	£24,577		£24,577
To Balance b/d	7,293		

(7) DEBTORS

	£		£
To Balance b/d	6,230	By Cash (1)	7,432
" Sales (1)	8,310	" Cash (2)	8,622
" Sales (2)	10,800	" Bad Debts	270
		" Balance c/d	9,016
	£25,340		£25,340
To Balance b/d	9,016		

Division of Profits. The methods of division of profits are unlimited, but the principles involved are usually simple, depending upon the method of computing the particular figure. As an illustration, the following may be considered as typical.

Illustration. A and B are partners sharing profits 3 : 2. Their capitals are £3,060 and £1,000. On 1st November, 19.., C enters the partnership, the terms being that he shall pay £500 for his share of the goodwill (which sum will be paid out to the other partners in their profit-sharing ratio) and introduce £500 capital, and that the profit and loss-sharing ratio be so adjusted that between A and B the former ratio is maintained, while between B and C there shall be the same ratio as between A and B.

The capitals are to be adjusted in cash (without disturbing the new total capital) so as to correspond with the new ratio, and interest on capital is to be taken at the rate of 5 per cent per annum throughout the period. The profits for the year before adjusting interest are £1,900, the proportion due to the period before and after the admission of C being found on the basis that profits are in uniform ratio to sales, the average monthly sales for the first eight months being twice as high as for the latter four months (i.e. 1st September to 31st December).

Show the partners' accounts and the Profit and Loss Appropriation Account for the year ended 31st December, 19... Entries are to be made to nearest £. Ignore Drawings.

Dr. **CAPITAL ACCOUNTS** *Cr.*

			A	B	C				A	B	C
19..			£	£	£	19..			£	£	£
Nov. 1	To Cash .		900			Jan. 1	By Balances		3,060	1,000	
Dec 31	" Balances .	c/d	2,160	1,440	960	Nov. 1	" Cash .				500
							" " .			440	460
			£3,060	£1,440	£960				£3,060	£1,440	£960
						19.. Jan. 1	By Balances	b/d	2,160	1,440	960

Dr. **CURRENT ACCOUNTS** *Cr.*

			A	B	C				A	B	C
19..			£	£	£	19..			£	£	£
Dec. 31	To Balances	c/d	1,142	718	40	Dec. 31	By Interest on Capital		146	54	8
							" Profits— (10 months)		924	616	
							(2 months)		72	48	32
			£1,142	£718	£40				£1,142	£718	£40
						19.. Jan. 1	By Balances	b/d	1,142	718	40

Dr. **PROFIT AND LOSS APPROPRIATION ACCOUNT** *Cr.*

		£	£	£				£
19.. Dec. 31	To Interest on Capitals				19.. Dec. 31	By Balance . . .	b/d	1,900
	A (10 months) .	128						
	(2 ") .	18						
			146					
	B (10 ") .	42						
	(2 ") .	12						
			54					
	C (2 ") .		8					
				208				
	" Profits (10 months)							
	A: $\frac{3}{5}$ . .	924						
	B: $\frac{2}{5}$ . .	616						
			[1]	1,540				
	" Profits (2 months)							
	A: $\frac{9}{19}$ . .	72						
	B: $\frac{6}{19}$ . .	48						
	C: $\frac{4}{19}$ . .	32						
			[2]	152				
				£1,900				£1,900

[1] £1,710 less Interest on Capital £170 = £1,540. (See page 620.)
[2] £190 less Interest on Capital £38 = £152. (See page 620.)

The interest is calculated as follows (to the nearest £)—

	£	£
5% per annum on—		
A—£3,060 for 10 months	128	
B—£1,000 ,, ...	42	
		170
A—£2,160 for 2 months	18	
B—£1,440 ,, ...	12	
C—£ 960 ,, ...	8	
		38
		£208

The profits are split up:

(*a*) As regards partners—

For the first ten months: A, $\frac{3}{5}$; B, $\frac{2}{5}$.

For the latter period this ratio must be maintained, and a similar one put into force between B and C. Thus—

A : B : C = 9 : 6 : 4

$\therefore$ For the last two months: A, $\frac{9}{19}$; B, $\frac{6}{19}$; C, $\frac{4}{19}$

(*b*) As regards time—

In the first eight months, the average monthly sales are twice as heavy as in the last four. Therefore, as the gross profits vary directly with sales, the profits will be apportioned thus—

$8 \times 2 = 16 : \quad 4 \times 1 = 4 \qquad$ Total, 20

In the first period of ten months $\frac{16}{20} + \frac{2}{20} = \frac{18}{20}$ of the profits have been earned, i.e. £1,900 $\times \frac{18}{20} =$ £1,710, and in the latter period of two months $\frac{2}{20}$, i.e. £1,900 $\times \frac{2}{20} =$ £190.

These amounts are split amongst the partners in the ratios shown above, less interest on capital for the appropriate period.

SECTION B. ADMISSION OF A PARTNER

The most important adjustments necessitated by the admission of a partner are those involved by the revaluation of the assets and liabilities at true values in place of book values.

Revaluation of Assets and Liabilities on an Admission

(1) **Values to be Altered in Books.** It has been seen that upon the admission of a partner it is necessary to make a revaluation of all the assets and liabilities so that the true position of the partners at the date of such admission may be ascertained.

Method 1. The entries are as follows—

(1) The assets at book values are debited to a Revaluation Account, corresponding credits being made in the Assets Accounts.

(2) The assets at **REVISED** values are debited to the Assets Accounts and credited to the Revaluation Account.

(3) The liabilities at book values are debited to the Liabilities Accounts and credited to the Revaluation Account.

(4) The liabilities at **REVISED** values are debited to the Revaluation Account and credited to the Liabilities Accounts.

(5) Depreciation in such assets as debtors, investments, and stock is treated by creating an appropriate provision, that is, the book values remain constant and are not passed through the Revaluation Account, or, if desired, may be shown on both sides at the same value. The amount of provision required, either new or to the extent of an increase, if any, is debited to Revaluation Account and credited to PROVISION Account, e.g. Investment Provision. If the provision is to be reduced or eliminated, the entries will be the reverse.

(6) The balance of Revaluation Account is treated precisely like a Profit and Loss Account balance, viz.—

(*a*) If there is an excess of debits over credits, the Revaluation Account is credited to balance off and the partners' Capital (or Capital Adjustment) Accounts are debited.

(*b*) If there is an excess of credits over debits the Revaluation Account is debited to balance off, and the partners' Capital (or Capital Adjustment) Accounts are credited.

Illustration. A and B are partners sharing profits equally. They decide to admit C as a partner. It is necessary to adjust the values of assets and liabilities in the books before C's admission.

BALANCE SHEET, AS AT 31ST DECEMBER, 19.

	£	£		£	£
Creditors . . .		1,000	Cash in Bank . .		600
Capitals—			Debtors . . .		1,500
A	1,700		Stock . . .		1,400
B	1,200		Fixtures . . .		400
		2,900			
		£3,900			£3,900

At this date (when C is to be admitted) it is found that the estimated value of the debtors is £1,200 and fixtures £250, whilst an investment not recorded in the books previously taken over in part payment of a debt is worth £400.

You are required to prepare (1) Journal entries; (2) Revaluation Account; and (3) Balance Sheet after giving effect to the above. For the purpose of this illustration, goodwill may be ignored.

JOURNAL

		£	£
19.. Dec. 31	Revaluation Account . . . . *Dr.*	700	
	To Fixtures		400
	,, Bad Debts Provision . . .		300
	Being transfers to Revaluation Account at date of C's admission.		
	Investments . . . . . . *Dr.*	400	
	Fixtures . . . . *Dr.*	250	
	To Revaluation Account . . .		650
	Being items revalued at date of C's admission.		
	A Capital . . . . . . *Dr.*	25	
	B ,, ... *Dr.*	25	
	To Revaluation Account . . .		50
	Being loss on revaluation transferred to Capital Account		

Dr. REVALUATION ACCOUNT *Cr.*

			£				£
19.. Dec. 31	To Fixtures		400	19.. Dec. 31	By Fixtures		250
	,, Bad Debts Provision .		300		,, Investments . .		400
					,, A Capital . .	£25	
					,, B ,, . .	25	
							50
			£700				£700

BALANCE SHEET (*after* giving effect to the above)

	£	£		£	£
Creditors . . .		1,000	Cash in Bank . .		600
A Capital . . .	1,700		Debtors . . .	1,500	
Less Loss on Revaluation . . .	25		*Less* Bad Debts Provision . .	300	
		1,675			1,200
B Capital . . .	1,200		Stock . . .		1,400
Less Loss on Revaluation . . .	25		Investments . .		400
			Fixtures . . .		250
		1,175			
		£3,850			£3,850

Alternatively the entries may be made as below–

Method 2.

Debit Revaluation Account with—

(*a*) Increased Liabilities (credit Liabilities).

(*b*) Decreased Assets (credit Assets).[1]

[1] In the case of Investments, Debtors, and Stock the old book value will be undisturbed and the credit will be to a Provision, e.g. Investments Provision.

Credit Revaluation Account with—

(*a*) Decreased Liabilities (debit Liabilities).
(*b*) Increased Assets (debit Assets).

The balance will be treated as profit or loss exactly as (6) in the previous set of entries. The entries for the foregoing revaluations will be—

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			£	£
19..				
Dec. 31	Investments . . . . . . *Dr.*		400	
	A Capital . . . . . . *Dr.*		25	
	B " . . . . *Dr.*		25	
	To Fixtures			150
	" Bad Debts Provision. . . .			300
	Being adjustments of values of assets and liabilities at date of C's admission.			
			£450	£450

The resultant Balance Sheet will be identical with that shown above.

(2) **Values to Remain Unaltered in Books.** Where the new firm desire to keep the old values of assets and liabilities unchanged in the books, the following procedure is adopted—

(*a*) The OLD firm credits the increase in value of assets (and/or decrease in amount of liabilities) to a *Memorandum* Adjustment or Revaluation Account and, instead of being posted to the Ledger Accounts, the items are **brought down on the opposite side,** in the manner of balancing an account. The credit in the top portion is closed by a transfer to the credit of the *old* partners' Capital or Current Accounts in the old profit ratio; whilst the debit below the line is treated as a **LOSS** to the NEW firm and closed by a transfer to the debit of Capital or Current Accounts of the *new* partners, just as if the increase in worth to the old firm has been actually lost at the very inception of the new firm.

(*b*) The converse procedure is followed in the case of a decrease in value of assets (and/or increase in amount of liabilities).

From the above figures the appropriate Journal entries are made and posted to the Ledger.

Illustration. If the altered values in the example on page 621 were not to be permanently recorded in the books (and assuming new profit-sharing ratio to be: A $\frac{3}{6}$, B $\frac{2}{6}$, and C $\frac{1}{6}$) the adjustment would be—

Dr. *Memorandum* REVALUATION ACCOUNT *Cr.*

19..				£	19..				£
Dec. 31	To Decrease in Value of Assets:				Dec. 31	By Increase in Value of Assets: Investments		c/d	400
	Fixtures	£150				,, Capital Accounts:			
	Debtors	300	c/d	450		A: $\frac{1}{2}$	£25		
						B: $\frac{1}{2}$	25		50
				£450					£450
19.. Jan. 1	To Reversal of Entry		b/d	400	19.. Jan. 1	By Reversal of Entries		b/d	450
	,, Capital Accounts:								
	A: $\frac{2}{5}$	£20							
	B: $\frac{2}{5}$	20							
	C: $\frac{1}{5}$	10		50					
				£450					£450

Dr. CAPITAL ACCOUNTS *Cr.*

		A	B	C			A	B	C
		£	£	£			£	£	£
To Loss on Revaluation		25	25		By Balances	b/d	1,700	1,200	
,, Balances	c/d	1,695	1,195	10	,, Loss on Revaluation written back		20	20	10
		£1,720	£1,220	£10			£1,720	£1,220	£10
					By Balances	b/d	1,695	1,195	10

Goodwill. It is not essential to the present purpose to enter into elaborate detail as to the precise significance of goodwill, nor into the numerous points connected with it, which are largely matters of academic discussion and argument; but none the less a clear conception of the basic idea is imperative.

Goodwill is an intangible, but not necessarily a fictitious, asset representing the value—however difficult its appraisement may be—to its owner of benefits arising from the business in question, such as the sole right to enjoy the profits of the business, and, where goodwill has been *acquired*, the sole right of succession to the advantages of the business which have been built up in the past. Goodwill arises mainly (*a*) by personal reputation of the owner, (*b*) by reputation of the goods dealt in, (*c*) by site monopoly or advantage, (*d*) by access to sources of supply, e.g. large quotas, and (*e*) for patent and trade-mark protection.

The purchaser of goodwill acquires the trade marks, patents, copyrights, etc., of the business as well as the benefits of contracts and all the benefits accruing from the location, reputation, connection, organization and other exceptional features of the business. The purchaser will seek to express the sum payable in terms of the compounded or capitalized value of an annuity of future differential or "super" profits, that is those profits in excess of the marginal return normally arising.

No formula can be laid down for the accurate measurement of the value of goodwill, and in practice a purchaser will be prepared to pay a sum representing a number of years' purchase of recent annual average profits, e.g. three years' purchase, according to the estimated worth to the buyer of the FUTURE earning capacity of the business, the risk of the discontinuance or diminution in such future profits being duly considered. Obviously, if the nature of the business is such that the profits are likely to decline, or that there is an abnormal risk of a discontinuance of reasonable earnings, the buyer will naturally reduce his buying price accordingly. Such circumstances as the business being largely successful owing to (1) the personality of the past proprietor, (2) the particular situation of the premises held on a short lease, (3) monopoly conditions which are not likely to continue, or (4) a temporary fashion or craze will also influence the goodwill estimate.

In the same way as a prospective purchaser is prepared to make a payment for goodwill in acquiring a business, so is a prospective partner prepared to lay out a sum for a *share* in a business. The principle is the same in both cases; in the first payment is for the *whole*, in the second for a *share* of the business. In both instances the owner, or owners, will require compensation for loss of benefits.

Following this rule, a retiring partner will naturally expect to receive compensation for the surrender of his rights in the partnership, whether a new partner be admitted or not.

The books of account may or may not record a figure for goodwill; in fact, unless arising by purchase, goodwill does not usually appear in the books, it being regarded as contrary to good accounting practice to write up a *created* goodwill.

Even if the record be made it may not represent the true value because of the inherent difficulties of valuation, particularly as from time to time the asset is susceptible to extreme fluctuations. Hence it is always necessary to find the true (or nearest possible approximation) value of goodwill, and for that matter of ANY OTHER ASSET and LIABILITY upon *any* change in the constitution of the firm—whether in respect of PERSONNEL or of PROFIT PROPORTIONS. Nor is the valuation less essential merely because at the time of change no record appears in the books of account.

The circumstances usually calling for the ascertainment of the true value of goodwill are—

(1) The admission of a new partner.

(2) The death or retirement of a partner.

(3) A combination of (1) and (2), i.e. where a new partner is substituted for an old partner.

(4) A dissolution of partnership, which includes the sale of the business to any other individual, firm, or company.

(5) A change in the ratio of sharing profits and losses by whatever name such shares are designated.

(6) A change in the mode of ascertaining profits and losses.

Calculation of Value. For the purpose of a sale, goodwill is generally valued on the basis of a number of years' purchase of the annual net profits calculated by reference to recent years and having regard to the probable maintenance of such profits in the future. No fixed number of years is used, but it will generally be from three to five, depending upon all the circumstances. When this method is used, the purchase-price will be either—

(*a*) the figure arising from the multiplication of the average profit by the number of years chosen, without modification, or

(*b*) that figure less deductions for—

(i) reasonable remuneration of management;

(ii) interest on capital, divided between (*a*) "pure" interest and (*b*) "risk" interest, or

(*c*) that figure used as the basis of a return from an investment, less the net assets other than goodwill.

Illustration. Goodwill is to be valued at two years' purchase of the average profits of the last five years, viz.—

£1,200; £1,800; £3,000; £800; £2,400; Total £9,200.

(1) Average profits $= \frac{9,200}{5} = £1,840$

(2) Two years' purchase $= 1,840 \times 2 = £3,680$

Illustration. The net assets of a business belonging to S are £6,000, exclusive of goodwill, and the profits are £1,500 per annum before charging any proprietorship salary, or interest on capital.

Assuming that these profits may reasonably be expected to continue and that the owner expects a minimum return of 4 per cent for "pure" interest—equivalent to that obtainable on a British Government Stock—and 8½ per cent for risk, together with a remuneration for service of £500, the super-profits will be—

Profits of business		£1,500
Less (1) "Pure" Interest on £6,000 at 4% p a. .	£240	
(2) "Risk" Return on £6,000 at 8½% p.a. .	510	
(3) Remuneration	500	
		1,250
Super profits		£250

As the proprietor expects a minimum return of 12½ per cent per annum on his capital invested in the business, the maximum valuation of goodwill is the sum invested at this rate that will produce a yearly return of £250, i.e. $\frac{100}{12\frac{1}{2}} \times £250 = £2,000$, although the valuation is often made by taking a certain number of years' purchase of the super profits.

Looking upon the business as the equivalent of an investment, the value of the business (having regard to risk involved and the return expected of businesses of a similar nature) taking a minimum return of 12½ per cent will be the sum invested at 12½ per

cent per annum, that will produce a yearly return of £1,000 [i.e. net profits of £1,500 less remuneration of management £500]. Such a sum equals $\frac{100}{12\frac{1}{2}} \times$ £1,000 = £8,000. As the net assets of the business, excluding goodwill, are £6,000, the value of goodwill is £2,000.

Thus, a purchaser of the above business would, given normal circumstances, be prepared to invest £8,000 therein, in order to derive an annual income of £1,500, the purchase price being comprised of two parts, viz. for net tangible assets, £6,000; and for goodwill, £2,000.

In respect of professional businesses where the earning capacity is largely based upon the individuality and personality of the proprietor, the saleable goodwill is normally less than that of a non-professional business. Usually the basis is two years' purchase of the annual recurring fees.

In all cases, ruling rates of interest will exert a strong influence on the question of the number of years to be taken for the calculation, the lower the ruling rate, the greater the number of years.

It is sometimes suggested that, when there are available profits, goodwill should be written down, but it will be seen that the higher the profits of a business, the higher is the goodwill value and if the profit trend is upwards so will be the goodwill value, and vice versa. Thus it is in adverse times that goodwill should really be written down.

GOODWILL ON ADMISSION OF A NEW PARTNER

Goodwill is dealt with on the introduction of a new partner as follows—

(1) **Where Goodwill is to be brought into the Books at the Revised Value.** Goodwill Account is created or adjusted to represent the value of the whole asset, the necessary credit being made to the Capital Accounts of the old partners in their old profit-sharing ratio. The total sum paid by the incoming partner, including that paid for his share of goodwill, is credited to his own Capital Account.

(2) **Where Goodwill is not to be brought into the Books.**

(*a*) MEMORANDUM REVALUATION METHOD. The created or adjusted goodwill is credited to the old partners in their old profit-sharing ratio and debited to the new partners in their new profit-sharing ratio. The total sum paid by the incoming partner, including that paid for his share of goodwill, is credited to his own Capital Account.

(*b*) PURCHASE AND SALE METHOD. The fractions of goodwill bought and sold by the partners are found, and adjustments are made between the partners for the sums represented by these fractions of the total goodwill. The total sum paid by the incoming partner, including that paid for his share of goodwill, is credited to his own Capital Account.

(c) Premium Method. (i) The sum paid by the incoming partner for his share of the total goodwill, being the same proportion of the whole goodwill of the firm as is his share of the total profits, is divided between the old partners in their old profit-sharing ratio.

This receipt may be dealt with—

(α) As a private transaction—no entries being made in the firm's books.

(β) As a firm transaction, the cash being immediately withdrawn.

(γ) As a firm transaction, the cash being retained in the business.

(ii) Where there is an *alteration* in the profit-sharing ratio between the *old* partners, a further adjustment is called for in respect of the share of goodwill passing from one old partner to another.

The premium method is convenient only when the profit-sharing ratio of the old partners *remains undisturbed*, because it entails a further adjustment. [See page 629 (c)(ii).]

Illustration. A and B were partners sharing profits in the ratio of 3 : 2. They agree to admit C as a partner, the new ratio of profit sharing to be 4 : 1 : 1. For the purpose of the change, goodwill is valued at £2,400. No figure for goodwill appears in the books. Make the necessary entries in Journal form.

Methods of Record. (1) *Where Goodwill is to be brought into the Books.*

Journal

		£	£
Goodwill . . . . Dr.		2,400	
To A—Capital: $\frac{3}{5}$			1,440
,, B— ,, $\frac{2}{5}$			960
Being Goodwill at the date of C's admission.			

(2) (*a*) *Memorandum Revaluation Method.* The whole goodwill is brought in at the old ratio and written out in the new ratio.

Journal

		£	£
Goodwill . . . . Dr.		2,400	
To A—Capital: $\frac{3}{5}$			1,440
,, B— ,, $\frac{2}{5}$			960
Being Goodwill at the date of C's admission.			
A—Capital : $\frac{4}{6}$ . . . . . . Dr.		1,600	
B— ,, $\frac{1}{6}$ . . . . . . Dr.		400	
C— ,, $\frac{1}{6}$ . . . . . . Dr.		400	
To Goodwill Account			2,400
Being the elimination of Goodwill from the books at the date of C's admission.			

	£	£
Net result is A in debit for . .	160	
C in debit for . .	400	
B in credit for . .		560

(*b*) *Purchase and Sale Method.* A schedule must be drawn up to ascertain the fractions of goodwill purchased or sold by each

partner, from which are obtained the requisite amounts for the appropriate Journal entries.

SCHEDULE OF SHARES OF GOODWILL
[Goodwill = £2,400]

	A	B	C
Old Shares Sold	$\frac{3}{5}$	$\frac{2}{5}$	—
New Shares Purchased	$\frac{4}{6}$	$\frac{1}{6}$	$\frac{1}{6}$
Differences	Buy $\frac{2}{30}$	Sell $\frac{7}{30}$	Buy $\frac{5}{30}$
	£160 *Dr.*	£560 *Cr.*	£400 *Dr.*

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		£	£
A—Capital . . . . *Dr.*		160	
C— ,, ... *Dr.*		400	
To B—Capital			560
Being adjustments in respect of purchase and sale of Goodwill on C's admission.			

(*c*) *Premium Method.* C will pay a premium of £400 on admission as a partner to take one-sixth share of the profits. This will be credited to A and B in their old profit-sharing ratio. As goodwill is not to be brought into the books, it is necessary further to adjust between A and B for the transfer of one-fifth of the *remaining* five-sixths goodwill belonging to A and B (after the sale of one-sixth to C), the ratio of sharing such five-sixths being altered from A $\frac{3}{5}$: B $\frac{2}{5}$ to A $\frac{4}{5}$: B $\frac{1}{5}$. The remaining goodwill is £2,000.

(i) JOURNAL

		£	£
C—Capital Account[1] . . . . . *Dr.*		400	
To A—Capital: $\frac{3}{5}$			240
,, B— ,, $\frac{2}{5}$			160
Being premium of £400 charged to C on his admission.			

(ii) JOURNAL

		£	£
A—Capital . . . . *Dr.*		400	
To B—Capital			400
Transfer of $\frac{1}{6}$ of the total Goodwill, being $\frac{1}{5}$ of A and B's *combined share* of such total from B to A on the alteration of the ratio in which they share their combined proportion of total profits from A $\frac{3}{5}$: B $\frac{2}{5}$ to A $\frac{4}{5}$: B $\frac{1}{5}$.[2]			

[1] This debit might be made direct to Cash or C's Loan Account.
[2] [i.e. $\frac{1}{5}$ × £2,000].

The combined result of the above entries is the same as that previously obtained.

Old Goodwill Figure to be Undisturbed

Problems frequently arise where the old goodwill figure is recorded in the books, and although the revised amount of goodwill must be utilized as the basis for the premium of a new partner, the old figure is to remain unaltered in the books.

The *undisclosed* goodwill must be treated just as if it were the true goodwill, methods (2) (*a*), (*b*) and (*c*) shown on pages 627 and 628 being applicable thereto. If the bare goodwill is *less* than that disclosed, converse entries should be made.

Illustration. A and B are partners sharing profits in the ratio of 3 : 2. Goodwill appears in the books at £4,000. C is admitted a partner for one-fifth share, paying therefor a premium of £1,000. Show the Journal entry in respect of the above, utilizing the "premium" method, assuming that the ratio of profit sharing as between A and B remains unchanged.

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			£	£
	C—Capital [1] . . . . . . *Dr.*		200	
	To A—Capital			120
	,, B— ,, ...			80
	Being premium charged to C for one-fifth share of the undisclosed Goodwill.			
	Cash . . . . *Dr.*		1,000	
	To C—Capital			1,000
	Being payment by C of the premium for one-fifth share of Goodwill.			

Illustration. Q and S sharing profits and losses in the ratio of 3 : 2 have been in partnership for several years.

O is to be admitted a partner to pay in cash for capital £600, and to have a one-tenth share in profits and losses. The premium for acquiring such share is £200, but he is unable to bring in cash.

Show how the position may be dealt with.

It is clear that the WHOLE goodwill is £2,000, i.e. £200 × 10, which belongs exclusively to Q and S. Accordingly, a Goodwill Account will be opened therefor and credited to the old partners' Capital Accounts in their *old* ratios. The Goodwill Account will either remain in the books or be written back by the reversal process.

[1] As C is acquiring one-fifth share of the Goodwill for £1,000, the whole Goodwill is £5,000, of which £4,000 already appears in the books of the firm. Hence the value of the *undisclosed* Goodwill is £1,000, C's share thereof being £200. As a result of being debited with £200 and credited with £1,000, C's Capital Account is credited with £800. If Goodwill realized £5,000, C would receive the £800 aforesaid, plus his one-fifth share of the profit on book value, such profit being £1,000.

Alternatively, the premium may be charged to O by way of loan —with or without interest—to be reduced out of profits. If the old partners change, as between themselves, their profit-sharing ratios, an adjustment of their Capital Accounts is necessary, as shown under Method (*c*) (ii) on page 629.

Distinction Between Contribution and Purchase of Share. A point of importance must now be considered, viz. the distinction between an actual contribution to the firm's assets and the purchase of a partner's share, and in both instances the question of goodwill arises. In the former case the firm's assets will be augmented by the amount paid in, whilst in the latter the only alterations will be in the shares of the partners *inter se*, the combined capitals as a *whole* remaining unchanged.

Illustration. A and B share profits equally and have equal capitals. Their Balance Sheet on C's admission (who is to pay in sufficient to give him a third share in the partnership) is—

A AND B BALANCE SHEET

	£		£
A Capital	3,000	Sundry Assets . . .	6,000
B ,, ...	3,000		
	£6,000		£6,000

C would contribute the sum of £3,000, the resulting Balance Sheet being—

A, B, AND C BALANCE SHEET

	£		£
A Capital	3,000	Sundry Assets . . .	6,000
B ,, ...	3,000	Cash	3,000
C ,, ...	3,000		
	£9,000		£9,000

Where he is to purchase his third SHARE from a partner (say B), the assets side (where goodwill is ignored) will remain unchanged, thus—

A, B, AND C BALANCE SHEET

	£		£
A Capital	3,000	Sundry Assets . . .	6,000
B ,, ...	1,000		
C ,, ...	2,000		
	£6,000		£6,000

Illustration. Taking the same facts as shown on page 631, with the addition of goodwill, on the assumption that C, on his admission, is to pay into the firm £5,000 for a third share in the partnership, the obvious inference is that A and B's combined share in the partnership must be twice that of C, and hence the total assets are £10,000. Goodwill, therefore, is £4,000 divided between A and B equally. The resultant Balance Sheet is—

A, B, AND C BALANCE SHEET

	£	£		£	£
A Capital . . .	3,000		Sundry Assets . .		6,000
Add Goodwill . .	2,000		Goodwill . .		4,000
		5,000	Cash . . .		5,000
B Capital . . .	3,000				
Add Goodwill . .	2,000				
		5,000			
C Capital . . .		5,000			
	£	15,000		£	15,000

If C is to purchase a portion of a partner's share for £5,000—in this case, a third share in the partnership from B—the inference is that the combined worth of the assets of A and B is three times £5,000, viz. £15,000. Hence the goodwill is £9,000, which will be divided equally between A and B.

A, B, AND C BALANCE SHEET

	£	£		£	£
A Capital . . .	3,000		Sundry Assets . .		6,000
Add Goodwill . .	4,500		Goodwill . .		9,000
		7,500			
B Capital . . .	3,000				
Add Goodwill . .	4,500				
	7,500				
Less Sale to C . .	5,000				
		2,500			
C Capital . . .		5,000			
	£	15,000		£	15,000

The same principle occurs on the *formation* of a partnership as distinct from the *admission* of a partner.

Illustration. A and B commence partnership as equal partners, A bringing in cash £2,000, and B sundry assets £3,000.

The assets would be debited in the ordinary way, A and B respectively being credited with £2,000 and £3,000, but if they are to have an *equal share in the partnership* the entries will be—

		£			£
Debit	Cash . .	2,000	Credit	A .	3,000
	Goodwill. .	1,000		B .	3,000
	Sundry Assets.	3,000			

If goodwill be ignored, the entries will be—

		£		£
either (*a*) Debit Cash . .		2,000	Credit A .	2,500
	Sundry Assets.	3,000	B .	2,500
or (*b*) Debit Cash . .		2,000	Credit A .	2,000
	Sundry Assets.	2,000	B .	2,000

If the respective interests were 2 : 1, A is to be assumed to bring in an equivalent of twice the assets of B, viz. £6,000, of which cash is £2,000, and, therefore, goodwill £4,000. The entries will be—

		£		£
Debit Cash . .		2,000	Credit A .	6,000
	Goodwill .	4,000	B .	3,000
	Sundry Assets.	3,000		

If goodwill be ignored, the entries will be—

		£		£	
either (*a*) Debit Cash . .		2,000	Credit A .	3,333	to nearest £
	Sundry Assets.	3,000	B .	1,667	
or (*b*) Debit Cash . .		2,000	Credit A .	2,000	
	Sundry Assets.	1,000	B .	1,000	

Adjustment of New Partner's Capital Account

An incoming partner may be required to contribute capital in the same proportion as his proposed profit sharing ratio; for instance, if he is to have one-quarter share of profits he must contribute one-quarter of the capital. This question is one largely of arithmetic, and students are apt to become confused in examination work because of neglect of obtaining proficiency in dealing with questions of this type so frequently presented to the examinee in an ambiguous manner. Leaving aside all other considerations, the various phases of this type of problem will now be considered.

(1) Incoming Partner to Contribute his Due Proportion of Capital, and the ORIGINAL Total Capital is to Remain Unchanged.

The rule in this case is that the incoming partner's capital contribution must be his profit proportion based upon the total capital existing at the date of his admission.

Illustration. A's and B's capitals are £3,000 and £2,000; they share profits in the same proportion. C is to have one-fifth share of the profits; A and B continuing to share as between themselves as before. C's capital to be proportionate to his profit-sharing ratio. The capital of the new firm is to remain at £5,000. Show Capital Accounts.

As C is to have one-fifth of the capital and the combined capital of the new firm is to remain at £5,000, he must contribute the sum of £1,000, and this sum will be taken out by A and B proportionately, thus—

	A	B	C	Total
	£	£	£	£
Original Capitals . . .	3,000	2,000	*nil*	5,000
Revised Capitals[1] . . .	2,400	1,600	1,000	5,000
Cash Adjustments . . .	Receive [2]£600	Receive £400	Pay £1,000	

(2) Where the Contribution by the Incoming Partner is to Remain in the Business. The proportionate contribution will be arrived at by taking the profit proportion and deducting from the denominator the amount of the numerator, e.g. one-fifth proportion becomes one-quarter, one-seventh becomes one-sixth, two-sevenths becomes two-fifths, and so on.

Illustration. Same facts as in the preceding illustration, except that the amount of C's contribution is to remain in the business, i.e. the new combined capital is to be increased by C's contribution.

The amount of capital C must introduce is $\frac{1}{5-1}$, i.e. $\frac{1}{4} \times$ £5,000, viz. £1,250.

The capitals, after C has contributed the £1,250, will appear—

A	B	C	Total
£	£	£	£
3,000	2,000	1,250	6,250

C thus has one-fifth of the combined capital.

A's share of profits is now $\frac{3}{5} \times \frac{4}{5} = \frac{12}{25}$.

B's share of profits is now $\frac{2}{5} \times \frac{4}{5} = \frac{8}{25}$.

As the original capitals of A and B were proportionate to their profit ratios, they should so remain after the above introduction of capital by C.

Thus A's capital is $\frac{12}{25} \times$ £6,250 = £3,000.

Thus B's capital is $\frac{8}{25} \times$ £6,250 = £2,000.

In problems of this nature the fact that the other partners' capital ratios are not equal to their profit ratios must be ignored, unless the question requires adjustment of *all* the capitals; in any case, in determining the amount of the incoming partner's capital the disproportionate ratios of capitals of the old partners may be ignored. Reverting to the preceding illustration, C must bring in either £1,000 or £1,250, as the case may be, quite irrespective of the composition of the old capital of £5,000.

If the capitals of A and B were disproportionate as between themselves, it would be advisable to adjust the position, e.g. if A's capital was £2,350 and B's capital was £2,650, A would pay and B would receive £650.

Restriction of Drawings until Capital Subscribed. On the admission of a new partner it is frequently stipulated that his drawings

[1] C thus has one-fifth of the combined capital.

[2] Withdrawals are "proportionate" if the original capitals are "proportionate."

shall be restricted to a certain amount until his capital has been augmented to an agreed figure.

The important feature is that the balance of the new partner's Current Account or Drawings Account is transferred at the end of each year to his Capital Account in pursuance of the agreement to bring it to the required amount.

Illustration. A admits his two sons B and C as partners. He placed to the credit of their Capital Accounts the sum of £3,200 and £800 respectively, representing a profit on revaluation of assets. The capital of A is £7,000. The partnership agreement provides—

(1) Interest on capital at 5 per cent per annum.

(2) Profits and losses to be shared in the ratio of 3 : 2 : 1.

(3) Drawings of B and C to be limited to £500 and £350 respectively, until their capitals become proportionate to their profit-sharing ratio.

The net profit of the first year *after* interest on capital was £5,400. The drawings were A £250, B £40, and C £25 per month.

Prepare Appropriation Account, Capital and Current Accounts of the partners.

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

		£	£			£	£
To Interest on Capitals—				By Balance .	b/d		5,950
A . .		350					
B . .		160					
C . .		40					
			550				
" Balance—							
A: $\frac{1}{2}$.		2,700					
B: $\frac{1}{3}$.		1,800					
C: $\frac{1}{6}$.		900					
			5,400				
			£5,950				£5,950

Dr PARTNERS' CURRENT ACCOUNTS *Cr*

		A	B	C			A	B	C
		£	£	£			£	£	£
To Drawings .		3,000	480	300	By Interest on Capitals		350	160	40
" Transfer to Capital Accounts .			1,467	640	" Profit .		2,700	1,800	900
" Balances .	c/d	50	13						
		£3,050	£1,960	£940			£3,050	£1,960	£940
					By Balances .	b/d	50	13	

Dr. **Capital Accounts** *Cr.*

		A	B	C			A	B	C
		£	£	£			£	£	£
To Balances	c/d	7,000	4,667	1,440	By Balance	b/d	7,000		
					,, Revaluation Account			3,200	800
					,, Current Accounts			1,467	640
		£7,000	£4,667	£1,440			£7,000	£4,667	£1,440
					By Balances	b/d	7,000	4,667	1,440

The capitals to be proportionate to profit-sharing ratios should be, taking A's to be the basic capital, A £7,000, B £4,667, C £2,333. B, having reached his capital quota, will be free from the original restriction on drawings, but C is short of the required quota by £893, i.e. (£2,333 − £1,440).

Illustration. A and B are partners sharing profits and losses equally. On 1st September, 19.., they admit C as a partner. The new profit ratios are 2 : 2 : 1. The profits for the year ended 31st December, 19.., are £3,000.

Interest on capital is 5 per cent per annum as and from 1st September, 19.., the capitals being: A, £1,800; B, £1,200; and C, £1,200.

A reserve is to be created of £100 at 31st December, 19...

C is to have a guaranteed minimum of £510 per annum, excluding interest on capital.

The profits are to be apportioned on a time basis. Goodwill is to be ignored. Show Profit and Loss Appropriation Account.

Profit and Loss Appropriation Account for the Year ended 31st December, 19..

Dr. *Cr.*

		A and B	A, B and C			A and B	A, B and C
		£	£			£	£
To Interest on Capitals:				By Balance	b/d	2,000	1,000
A			30				
B			20				
C			20				
,, Reserve			100				
,, Balance, Net Profit:							
A		($\frac{1}{2}$) 1,000	($\frac{2}{5}$) 332				
B		($\frac{1}{2}$) 1,000	($\frac{2}{5}$) 332				
C			($\frac{1}{5}$) 166				
		£2,000	£1,000			£2,000	£1,000

It is assumed that the reserve represents undistributed profits and is debited against the new firm, because, if and when it is

restored, it will be credited to all the partners in the ratio of 2 : 2 : 1, assuming no further change in the constitution of the partnership.

C is entitled to a guaranteed minimum of £170 for the four months ended 31st December, 19. . ; but as his proportion of reserve is £20, his *real* share of profits is £186,[1] so that no adjustment is necessary. If, on the other hand, the partners agree to increase C's share of the profits as shown by the Profit and Loss Appropriation Account to £170, there will be a transfer of £4 to the credit of C and £2 each to the debit of A and B; but in this event, when the reserve is recredited to the partners, a reversing adjustment of £4 will be required.

The position may be shown by assuming that the reserve is to be eliminated on the 1st January following.

	(1) Where no Reserve was created	(2) Where Reserve created and C credited with £166 and Reserve cancelled		Total	(3) Where Reserve created and C credited with £170 and Reserve cancelled			Total
	£	£	£	£	£	£	£	£
A— . .	372	332 +	40	= 372	330 +	40 +	2	= 372
B— . .	372	332 +	40	= 372	330 +	40 +	2	= 372
C—$\frac{1}{5}$ . .	186	166 +	20	= 186	170 +	20 −	4	= 186
Total .	[2]£930	£830 + £100		£930	£830 + £100			£930

If the reserve is in respect of a *liability*,[3] it will be charged according to the time or period when the necessity arose; or apportioned between the old and the new firm on a time basis, i.e. £66 13s. 4d. and £33 6s. 8d. In the latter case the balance of profits would be £896 13s. 4d., of which C's share is £179 6s. 8d., which exceeds his guaranteed minimum.

If the reserve was in respect of a *liability* existing on 1st September, the old partners might have dealt with it by debiting their accounts equally and crediting reserve. Further, they might have decided to reverse the above entry and charge it as a new firm (i.e. 2 : 2 : 1) loss, in which case the debit to Profit and Loss Appropriation Account would be against the new firm. C would thus have been credited with one-fifth reserve at 1st September and £166 at 31st December, i.e. £186 being one-fifth of the profit of £930, no adjustment being required for the guaranteed minimum. This has the same effect as if the reserve at 1st September had not been brought in till 31st December, and charged in the Profit and Loss Appropriation Account entirely against the old firm.

If the reserve is in respect of a *liability* arising since the 1st September, the Profit and Loss Appropriation Account gives the true

[1] I.e. £166 + £20
[2] I.e. £1,000 − £70
[3] I.e. A provision

profit necessitating an adjustment of £4 for guaranteed minimum, that is, to bring C's share of profit up from £166 to £170.

SECTION C. AMALGAMATIONS AND ACQUISITIONS OF BUSINESSES

Amalgamation

Where a new partner brings into the firm assets with or without liabilities, it is usually in consequence of an amalgamation of two businesses, and the question of valuation of the assets and liabilities, of both businesses will require settlement before the introduction of the new partner into the firm, so that the true capitals are shown at the date of such amalgamation.

The entries are similar to those occasioned by a purchase of a business, viz.—

Debit Assets acquired.
Credit Liabilities assumed.
Credit Vendor (i.e. new partner's capital).
The entries in Journal form therefore are—

Journal

Date	Sundry Assets (detailed) . . . . *Dr.* To Sundry Liabilities (detailed) . . ,, New Partner's Capital . . . Being assets and liabilities introduced by ..... at this date as per agreement dated		

Illustration. A and B are partners sharing profits equally.

Balance Sheet as at 1st January, 19..

	£	£		£
Capital—			Cash . . .	300
A . . .	1,500		Debtors . . .	1,200
B . . .	1,000		Stock . . .	1,500
		2,500		
Creditors . . .		500		
		£3,000		£3,000

C is to be admitted as partner to have one-quarter share in profits and losses; and to contribute the assets less liabilities of his own business, which for this purpose are valued at £800, goodwill to be ignored. The assets and liabilities of C as revalued are Stock £450, Debtors (Book Value £692) £550, Cash £100; Creditors £300.

Show Journal entries and resulting Balance Sheet of new firm.

A, B, AND C JOURNAL

19..			£	£
Jan. 1	Stock	*Dr.*	450	
	Debtors	*Dr.*	692	
	Cash	*Dr.*	100	
	To Creditors			300
	,, BAD DEBTS PROVISION			142
	,, C Capital			800
	Being assets and liabilities introduced by C at this date as per agreement dated		£1,242	£1,242

BALANCE SHEET AS AT 1ST JANUARY, 19..

	£	£		£	£
Capital—			Cash		400
A	1,500		Debtors	1,892	
B	1,000		*Less* Bad Debts Provision	142	
C	800	3,300			1,750
Creditors		800	Stock		1,950
		£4,100			£4,100

Illustration. A and B with a London office share profits 3 : 2, and amalgamate with C with a Manchester office, on the following terms—

	A	B	C
Profits of London	$\frac{1}{2}$	$\frac{1}{4}$	$\frac{1}{4}$
Profits of Manchester	$\frac{3}{10}$	$\frac{1}{5}$	$\frac{1}{2}$

The Goodwill of A and B is £4,000 and C £1,600 and an adjustment is required in respect of the goodwill attributable to each but the asset is not to appear in the books. Show the necessary entries.

Dr. REVALUATION ACCOUNT—A AND B *Cr.*

	£		£	£
To A—$\frac{3}{5}$	2,400	By Goodwill introduced c/d		£4,000
,, B—$\frac{2}{5}$	1,600			
To Goodwill cancelled b/d	£4,000	By A—$\frac{1}{2}$	2,000	
		,, B—$\frac{1}{4}$	1,000	
		,, C—$\frac{1}{4}$	1,000	
				£4,000

Dr. REVALUATION ACCOUNT—C *Cr.*

	£		£	£
To C	1,600	By Goodwill introduced c/d .		£1,600
To Goodwill cancelled b/d	£1,600	By A . . .	480	
		,, B . . .	320	
		,, C . .	800	
				£1,600

ADMISSION OF PARTNER OR AMALGAMATION DURING A FINANCIAL PERIOD

Where a partner is admitted or an amalgamation takes place *during* the financial year, it is necessary to agree upon some mutually acceptable basis of arriving at profits prior to, and subsequent to, the date of admission, e.g. on a turnover or time basis, or other reliable data. Care should be exercised in the division as interest on capital (being an appropriation of profits) must not be charged *before* the ascertainment of the profits; whilst should a guarantee be given to the incoming partner the amount in the first accounts (as with interest on capital) will be proportionate to the period in which the new partner has been a partner.

Illustration. A and B, who made up their accounts yearly to 31st December, decided to amalgamate with C and D, who made up their accounts to the 30th June of each year. The amalgamation was to take place as from 1st July, 1952, and the first accounts of the new firm A, B, C, and D were to be drawn up to 30th June, 1953. As stock had not been taken at the date of merger, it was agreed that A and B should have 10 per cent of their net sales for that period in lieu of their actual profits.

Profits were shared as follows—

A and B: A, $\frac{3}{5}$; B, $\frac{2}{5}$.
C and D: C, $\frac{1}{2}$; D, $\frac{1}{2}$.

and in the new firm it was agreed that as between A and B, and C and D the same ratios were to continue, A and B taking half of the profits and C and D half.

The Trial Balance of the new firm at 30th June, 1953, is as follows—

TRIAL BALANCE

	Dr.	*Cr.*
	£	£
Capital—		
A		6,000
B		4,000
C		3,000
D		3,000
Sundry Assets	20,000	
Sales—		
A and B: ½ yr. to 30th June, 1952		5,000
A, B, C, and D: year to 30th June, 1953		24,000
Purchases	18,000	
Stock—		
A and B: 1st January, 1952	5,000	
C and D: 1st July, 1952	3,000	
Selling and Administration Expenses	6,000	
Creditors		7,000
	£52,000	£52,000

Assuming the closing stock to be £10,000, show the Trading and Profit and Loss Account of A, B, C, and D for the period to 30th June, 1953, and the Balance Sheet at that date. Show the division of the profit in a separate section.

TRADING AND PROFIT AND LOSS ACCOUNT
FOR THE PERIOD ENDED 30TH JUNE, 1953

Dr.				*Cr.*		
			£			£
To Stock—				By Sales		29,000
A and B			5,000	,, Stock		10,000
C and D			3,000			
,, Purchases			18,000			
,, Gross Profit		c/d	13,000			
		£	39,000		£	39,000
To Selling and Administration Expenses			6,000	By Gross Profit	b/d	13,000
,, Balance		c/d	7,000			
		£	13,000		£	13,000
To A and B: 10% of £5,000—				By Balance	b/d	7,000
A. 3/5	£300					
B. 2/5	200					
			500			
,, A and B: ½ of £6,500—						
A. 3/5	£1,950					
B. 2/5	1,300					
			3,250			
,, C and D: ½ of £6,500—						
C. ½	£1,625					
D ½	1,625					
			3,250			
			£7,000			£7,000

A, B, C, AND D BALANCE SHEET AS AT 30TH JUNE, 1953

	£	£			£
Capital—			Sundry Assets . .		20,000
A . . .	6,000		Stock . . .		10,000
B . . .	4,000				
C . . .	3,000				
D . . .	3,000				
		16,000			
Current Accounts—					
A . . .	2,250				
B . . .	1,500				
C . . .	1,625				
D . . .	1,625				
		7,000			
Sundry Creditors .		7,000			
	£	30,000		£	30,000

Illustration. A and C decided to amalgamate their businesses on 1st January, 19... Their Balance Sheets were—

BALANCE SHEETS AS AT 1ST JANUARY, 19..

	A	C		A	C
	£	£		£	£
Creditors . . .	2,500	1,700	Sundry Assets . .	5,000	2,000
Capitals . . .	3,780	1,380	Stock . . .	480	680
			Debtors . . .	800	400
	£6,280	£3,080		£6,280	£3,080

Assets are to be taken over on the basis that sundry assets and stock are worth book values, debtors of A worth £620, of C £320. C to bring in cash £2,000. Goodwill to be valued, A £500 and C £300, and to be brought into the books at the combined value. Profits to be shared 3 : 2. Show opening entries in Journal form and combined Balance Sheet of the new firm.

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			£	£
19..				
Jan. 1	Sundry Assets	*Dr.*	5,000	
	Stock	*Dr.*	480	
	Debtors	*Dr.*	800	
	Goodwill	*Dr.*	500	
	To Bad Debts Provision . .			180
	,, Creditors			2,500
	,, A Capital			4,100
	Being assets and liabilities introduced by A into the partnership on this date, as per agreement dated.......... ..		£6,780	£6,780

JOURNAL (*Contd.*).

		£	£
19.. Jan. 1	Sundry Assets . . . . . *Dr.*	2,000	
	Stock . . . . . . *Dr.*	680	
	Debtors . . . . . . *Dr.*	400	
	Goodwill . . . . . . *Dr.*	300	
	To Bad Debts Provision . .		80
	,, Creditors		1,700
	,, C Capital		1,600
	Being assets and liabilities introduced by C into the partnership on this date, as per agreement dated	£3,380	£3,380
	Cash . . . . *Dr.*	2,000	
	To C Capital		2,000
	Being cash introduced on this date as per agreement.		

A AND C COMBINED BALANCE SHEET AS AT 1ST JANUARY, 19..

	£	£		£	£
Creditors		4,200	Sundry Assets . .		7,000
Capital—			Goodwill . .		800
A	4,100		Stock . . .		1,160
C	3,600		Debtors . . .	1,200	
		7,700	*Less* Bad Debts Provision . .	260	
					940
			Cash . . .		2,000
		£11,900			£11,900

If goodwill is not to be retained in the books, it is necessary for a transfer of £20 to be made to the credit of A and to the debit of C, as A sells two-fifths of his goodwill to C, and buys three-fifths of C's goodwill, viz.—

	£
Sale: $\frac{2}{5}$ × £500	200
Purchase: $\frac{3}{5}$ × £300	180
Net Sale by A . . .	£20

This can be seen by the fact that if the goodwill was ignored in the opening entries of the partnership, (the respective capitals being proportionately less than shown in the foregoing entries) and subsequently introduced into the books, there would be a book profit of £800, shared as follows—

	£
A: $\frac{3}{5}$ = £480 as against true share .	500
C: $\frac{2}{5}$ = £320 as against true share .	300

Assets and Liabilities Not Taken Over. Where a business is acquired it not infrequently happens that certain assets and liabilities are not taken over by the purchaser, e.g. an insurance policy. If a Balance Sheet is prepared at the date of acquisition from which entries are made in the new books, the non-acquired items do not appear amongst the opening entries, so the exclusion is automatic;

but where the same set of books is continued it is necessary to make eliminating entries through the Vendor's Account or Purchase of Business Account, and for this purpose it will be necessary to prepare a Balance Sheet or a statement of assets and liabilities as at the date of acquisition, so as to ascertain the amount due to the vendor.

The adjustments required for eliminating the non-acquired items are best explained by the employment of an illustration followed by the formal rules.

Illustration. The following is the position at 1st May, 19.., of A, who sells his business to X and Y on this date.

A Balance Sheet as at 1st May, 19..

		£			£
Creditors	T	1,500	Sundry Assets	T	1,400
Bill Payable	R	240	Debtors	T	1,350
Capital	R	1,500	Car	R	420
			Loan	R	70
		£3,240			£3,240

X and Y take over at book values, ignoring goodwill. Items marked T are taken over, and items marked R are retained by vendor. X and Y equally contribute the sum of £2,000. Show the necessary entries.

(1) If new books are opened the Journal entries are—

Journal

				£	£
19.. May 1	Sundry Assets	Dr		1,400	
	Debtors	Dr.		1,350	
	To Creditors				1,500
	,, Vendor				1,250
	Cash	Dr.		2,000	
	To X Capital				1,000
	,, Y ,,				1,000
	Vendor	Dr.		1,250	
	To Cash				1,250

Cash has been journalized in order to present the whole transactions together, and narrations have been excluded. The Balance Sheet will be—

X and Y Balance Sheet as at 1st May, 19..

	£	£			£
Creditors		1,500	Sundry Assets		1,400
Capital—			Debtors		1,350
X	1,000		Cash		750
Y	1,000				
		2,000			
		£3,500			£3,500

(2) If the old books are continued the accounts are—

Dr. PURCHASE OF BUSINESS ACCOUNT Cr.

		£			£
To Vendor[1]		1,250	By Bill Payable		240
" Car		420	" Capital		1,500
" Loan		70			
		£1,740			£1,740

Dr. VENDOR Cr.

		£			£
To Cash		1,250	By Purchase of Business Account		1,250

Dr. CASH Cr.

		£			£
To X		1,000	By Vendor		1,250
" Y		1,000	" Balance	c/d	750
		£2,000			£2,000
To Balance	b/d	750			

The Balance Sheet may now be drawn up in respect of the items remaining which will be precisely the same as in (1).

It is obvious that if every item in the Balance Sheet at the date of acquisition of the business is in the books, then those not acquired must be eliminated as T = R, i.e.

"T" items	£	"R" items		£
Sundry Assets	1,400	*Bill Payable*		*240*
Debtors	1,350	*Capital*		*1,500*
	2,750			*1,740*
Less Creditors	1,500	Less *Car*	*£420*	
		" *Loan*	*70*	
				490
Net DEBITS	£1,250 =	*Net CREDITS*		*£1,250*

The italicized items are eliminated through the Purchase of Business Account.

[1] Alternatively, the Purchase of Business Account may be dispensed with, in which case all the items contained in such account and Vendor will appear in one account under the heading of Vendor, except the transfer between the two accounts (e.g. the transfer of £1,250 from Purchase of Business Account to Vendor); the transactions would be recorded thus—

Dr VENDOR Cr.

	£		£
To Car	420	By Bill Payable	240
" Loan	70	" Capital	1,500
" Balance c/d	1,250		
	£1,740		£1,740
To Bank	£1,250	By Balance b/d	£1,250

Where the precise position is ascertained and dealt with as outlined, the profits or losses up to the date of acquisition are automatically reflected in the statement drawn up at such a date, otherwise it will be necessary to apportion the profits or losses of the business to and from the date of the sale thereof through the Purchase of Business Account. In practice, moreover, goodwill will usually have to be dealt with and this, again, will be adjusted through the Purchase of Business Account. Reverting to the preceding illustration, if the purchase price had been £1,350 (i.e. £100 for goodwill), the Purchase of Business Account would have been debited with £1,350, leaving a debit balance of £100 after making the entries as shown in that account. Hence, an entry to the debit of Goodwill Account (£100) and a credit to Purchase of Business Account (£100) are required.

The entries required for disposing of items *not* taken over in the case of the whole assets, liabilities, and capital appearing in the books at the date of acquisition, that is, where the old books are continued, may now be summarized—

(1) Debit Purchase of Business Account (*abbreviated below to P.B.*) and credit vendor with the **purchase consideration** of the business acquired.

(2) Debit P.B. with **assets not taken over** (i.e. retained by vendor) and credit Asset Accounts.

(3) Debit **liabilities not acquired** (i.e. to be discharged by the vendor) and credit P.B.

(4) Debit Profit and Loss Account with **profit to date of acquisition,** and credit P.B.; or debit P.B. with **loss to date of acquisition,** and credit Profit and Loss Account.

(5) Debit goodwill and credit P.B. for **goodwill.**

(6) Debit P.B. and credit assets or provision (or reserve) in respect of reductions in book value of assets, and conversely for increase in book value of assets.

(7) Reverse entries to (6) in respect of alterations in amounts of liabilities.

(8) Debit Vendor's Capital Account and credit P.B. to eliminate **Vendor's Capital Account.**[1]

(9) Debit vendor and credit cash upon payment of purchase consideration.

The principles involved in dealing with such circumstances will now be illustrated.

Illustration. On page 647 is the Balance Sheet of A and B on 31st December, 1952.

On 30th April, 1953, X acquires the business, taking over debtors £1,800, fittings £300, stock £700, less creditors £1,300, i.e. net assets of £1,500, and agrees to pay therefor the sum of £1,800.

[1] Alternatively, the Vendor's original Capital Account can be utilized instead of Vendor Account, so that this transfer will not arise.

BALANCE SHEET AS AT 31ST DECEMBER, 1952

	£	£			£
Creditors		1,250	Debtors		1,500
Bank Loan		450	Stock		550
Capital—			Fittings		300
A	1,000		Investments		650
B	700		Insurance Policy		400
		1,700			
		£3,400			£3,400

On 31st December, 1953, the Trial Balance is—

		Dr. £	Cr. £
Stock		550	
Fittings		300	
Investments	(a)	650	
Insurance Policy	(b)	400	
Purchase of Business Account		1,800	
Bank Loan	(c)		450
Capitals: A	(d)		1,000
B	(e)		700
X			2,300
Bank		890	
Debtors		1,830	
Creditors			1,230
Purchases		7,200	
Sales			8,180
Expenses		240	
		£13,860	£13,860
Closing Stock £480.			

Between 1st January, 1953, and 30th April, 1953, there have been no alterations to the amounts shown in the books in respect of the items which are not to be acquired by X from A and B.

Prepare final accounts showing in detail the Purchase of Business Account.

The Trial Balance, it will be observed, includes the *whole* of the assets and liabilities; consequently, eliminating entries are required in order to exclude assets and liabilities RETAINED by the vendor, applying the rules outlined on the previous page.

These will be—

Dr. PURCHASE OF BUSINESS ACCOUNT *Cr.*

		£			£
To Balance	b/d	1,800	By Loan	(c)	450
„ Investments	(a)	650	„ Capital A	(d)	1,000
„ Insurance Policy	(b)	400	„ Capital B	(e)	700
			„ Goodwill[1]		300
			„ *Profit and Loss Account*		*400*
		£2,850			£2,850

[1] Goodwill Account will be opened in the usual way.

PROFIT AND LOSS ACCOUNT
FOR THE YEAR ENDED 31ST DECEMBER, 1953

Dr.			£			Cr. £
To Stock			550	By Sales		8,180
,, Purchases			7,200	,, Stock		480
,, Gross Profit		c/d	910			
			£8,660			£8,660
To Expenses			240	By Gross Profit	b/d	910
,, Profit—						
X	£270					
A and B[1]	400					
			670			
			£910			£910

X. BALANCE SHEET AS AT 31ST DECEMBER, 1953

	£	£		£
Creditors		1,230	Bank	890
X Capital	2,300		Debtors	1,830
Add Profit per Profit and Loss Account	270		Stock	480
			Fittings	300
		2,570	Goodwill	300
		£3,800		£3,800

The profits arising prior to the sale of the business may be confirmed by showing a Statement of Affairs on 30th April, 1953, viz.—

STATEMENT OF AFFAIRS AS AT 30TH APRIL, 1953

Liabilities	£	*Assets*	£
Creditors	1,300	Debtors	1,800
Bank Loan	450	Stock	700
Capital at 31st December, 1952	1,700	Fittings	300
Profit	400	Investments	650
		Insurance Policy	400
	£3,850		£3,850

SECTION (D) RETIREMENT OF PARTNER

Retirement or Death of Partner. Upon the retirement or death of a partner, the balance due to him or his estate is the first matter that claims attention. Just as it has been seen that prior to the introduction of a new partner, the old partners will usually adjust their Capital Accounts by revaluation, so in the case of retirement or death of a partner a revaluation—subject always to the provisions of the partnership agreement—will take place in order to arrive at the true balance due to the ex-partner.

Where no adjusting entries are required, a simple transfer will be made by debiting Capital Account and crediting Loan Account of the retired or deceased partner; in addition, if other accounts

[1] Credited to Purchase of Business Account.

relating to the latter exist, e.g. Drawings Account and Current Account, they must be transferred to the Loan Account.

In the event of the accounts being drawn up to the date of death or retirement, no departure from the normal procedure arises, but it will be necessary to see that every revaluation required by the terms of the partnership agreement is made. It has been laid down judicially that, in the absence of contrary agreement, all assets and liabilities must be taken at a "fair value," not merely a "book value" basis, thus involving recording entries for both appreciation and depreciation of assets and liabilities. This rule is applicable, notwithstanding the omission of a particular item from the books, e.g. investments, goodwill (*Cruikshank* v. *Sutherland*). Obviously, the net effect of the revaluation will be a profit or loss divisible in the agreed profit- or loss-sharing ratios.

Goodwill will be payable to the outgoing partner, always subject to the terms of the partnership agreement, e.g. in *McLeod* v. *Dowling* (see page 557).

Just as upon the admission of a new partner, so in the present circumstances the revaluations made for the purposes of dissolution may be written back, but clearly such procedure cannot affect the amount due to the retired or deceased partner. It will be recollected that the rule of procedure is to take the result of the revaluation as a profit (or loss) to the old firm, and the reversal as a loss (or profit) to the new firm, so that if A, B, and C are partners sharing profits in the ratio of 3 : 1 : 1 and C retires, any profit on revaluation will be divided in that ratio, and, if reversed, debited against A and B either as to 3 : 1 or in some other ratio, if upon C's retirement a change of profit sharing is agreed upon.

Illustration. Q, S and O are in partnership sharing profits and losses in the ratio of 3 : 3 : 1.

Q, S and O Balance Sheet as at 31st December, 19 .

	£	£		£
Capital—			Cash	22,000
Q	10,000			
S	8,000			
O	4,000			
		22,000		
	£	22,000	£	22,000

At this date Q decided to retire, and goodwill is valued in accordance with the partnership agreement at £8,000. In addition, the firm holds $3\frac{1}{2}$ per cent Conversion Loan to the cash equivalent of £2,500.

S and O decide to carry on the business, sharing profits equally. You are required to show the amount due to Q and to give the necessary Journal entries to record the above transactions, and to show the new Balance Sheet of S and O.

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			£	£
19.. Dec. 31	Goodwill	Dr.	8,000	
	$3\frac{1}{2}$% Conversion Loan . . .	Dr.	2,500	
	To Q Loan			4,500
	" S Capital			4,500
	" O "			1,500
	Being the insertion in the books of unrecorded assets at this date.			
	Q Capital	Dr.	10,000	
	To Q Loan			10,000
	Being transfer of Capital Account to Loan Account			
	Q[1] Loan	Dr.	14,500	
	To Cash			14,500
	Being the discharge of liability to Q.			

S AND O BALANCE SHEET AS AT 1ST JANUARY, 19..

	£		£
Capitals—		Cash	7,500
S (£8,000 + £4,500) .	12,500	$3\frac{1}{2}$% Conversion Loan . .	2,500
O (£4,000 + £1,500) .	5,500	Goodwill	8,000
	£ 18,000		£ 18,000

Illustration. A, B, and C are partners sharing profits in the ratio of 3 : 2 : 1. At 31st December, 19.., B retires.

It is agreed that all the assets and liabilities shall be revalued.

The following are the material facts—

	Revised Values £		£
Goodwill	2,000	in the books at	Nil
Reserve	500	" "	500
Workmen's Compensation Fund estimated claims	190	" "	420
Debtors	1,000	" "	1,250
Creditors	900	" "	800
Joint Life Policy	300	" "	400
Hire Purchase Machinery . . . . *(All paid for, except £50 agreed to be brought in as a liability and paid on the day after B's retirement)*	300	" "	Nil
Investments . . . . . . *(Investments Provision stands at £400)*	1,500	" "	3,000
Accrued Income on Investments . .	100	" "	Nil

A and C are to continue the business with profit-sharing ratio of 3 : 2—the book values to remain unchanged. Prepare Memorandum Revaluation Account.

[1] Actually this entry would not be journalized, but posted direct from the Cash Book.

Dr. *Memorandum* REVALUATION ACCOUNT *Cr.*

19..			£	19..			£
Dec. 31	To Bad Debts Provision .	c/d	250	Dec. 31	By Goodwill Introduced .	c/d	2,000
	,, Creditors (or Provision) . .	,,	100		,, Reserve	,,	500
	,, Life Policy . .	,,	100		,, Workmen's Compensation Fund .	,,	230
	,, Creditors (*re* H. P.) .	,,	50		,, Machinery[1] . .	,,	300
	,, Investments Provision	,,	1,100		,, Dividends Accrued .	,,	100
	,, A Capital Account: [illegible] . £765						
	,, B Loan Account: [illegible] . 510						
	,, C Capital Account: [illegible] . 255		1,530				
			£3,130				£3,130
19..				19..			
Jan. 1	To Reversal of Items .	b/d	3,130	Jan. 1	By Reversal of Items .	b/d	1,600
					,, A Capital Account: $\frac{3}{5}$. £918		
					,, C Capital Account: $\frac{2}{5}$. 612		1,530
			£3,130				£3,130

It should be remembered that whilst the reserve is not altered, if the item indicates, not a liability, but undistributed profits, it belongs to the partners. In other words, in the Balance Sheet the reserve will have appeared on the liabilities side, but as in reality it is not a liability it must be brought to the credit of revaluation account, so that the retiring partner duly obtains his share thereof.

Further provision for depreciation of investments is £1,100, as there already exists a provision of £400.

The effect of the above is that it provides the basis for the Journal entries, either showing the adjustment of the profit in one set and the adjustment of the reversal in another set, or consolidated into one set of entries only.

The same principles apply where some of the revaluations are brought into the books permanently and the others written back.

Illustration. A and B are partners sharing profits equally. B retires, and it is agreed to bring into account for dissolution purposes—

(*a*) Capital expenditure on fixtures £300 (depreciation £40).
(*b*) Pension Fund liability, £1,000.
(*c*) Bad Debts provision of £200.

A writes back the Pension Fund and the Fixtures.
Show Memorandum Revaluation Account.

[1] The true value will be considerably less than £300 owing to depreciation, but seeing that no information is given as to date of purchase and rate of depreciation, the amount of £300 will be inserted and a suitable footnote made. If the depreciation has been, say, £40, the figure of £260 would be substituted for £300.

Dr. *Memorandum* REVALUATION ACCOUNT *Cr.*

		£			£
To Bad Debts Provision[1]		200	By Fixtures . . .	c/d	260
,, Pension Fund	c/d	1,000	,, Balance—		
			A. ½ . . £470		
			B. ½ . . 470		
					940
		£1,200			£1,200
To Reversal of Item .	b/d	260	By Reversal of Item .	b/d	1,000
,, Balance—A . .		740			
		£1,000			£1,000

LAST BALANCE SHEET BASIS OF DETERMINING PARTNER'S SHARE

Share of profit of outgoing partner. It frequently happens that a partner retires during the course of a normal accounting period. He will be entitled in the ordinary way to his share of profit, including interest on capital, if any, to the date of retirement. This will be ascertained by—

(1) drawing up accounts to the actual date of retirement, or

(2) drawing up accounts for the full normal accounting period and splitting them into the (*a*) pre- and (*b*) post-retirement period.

The former method is the more satisfactory, but circumstances may prevent this being carried out. In regard to the second method, the procedure is—

(1) Prepare the Profit and Loss Account for the whole period excluding those items, whether debit or credit, which are not apportionable on a normal time basis.

(2) Apportion the balance of the account in (1) on a time basis into—

(*a*) pre- and (*b*) post-retirement.

(3) Debit or credit, as the case may be, any of the remaining items which refer to one specific period.

(4) Debit or credit, as the case may be, any of the remaining items which, though related to the whole year, are not apportionable on a time basis.

(5) Where assets are revalued, depreciation should be apportioned between the two periods and any profit or loss on revaluation dealt with through the partners' accounts in the usual way.

(6) Bring down the balance into the Appropriation section, divided between the two periods.

(7) Debit the Appropriation section with the usual appropriations, viz. partners' salaries, interest on capital and share of profit apportioned on a time basis, and similarly with the usual credits, subject to—

(*a*) No entries being made in respect of the retired partner *after* the date of retirement, i.e. in the second period column.

[1] This item will be posted to the credit of Bad Debts Provision

(*b*) If one partner alone remains there will be no point in entering up interest on capital, etc., in the second period.

(*c*) An amount representing interest on the amount due to the retired partner will be debited in the post-retirement column.

In regard to (1), an alternative method of arriving at the same result is to prepare the accounts for the whole period, and then to add back debits and deduct credits which have been included but which are not apportionable on a time basis.

Illustration. The profits of A, B, and C, equal partners, for the year ended 31st December are £4,800. C retires on 30th September, it being agreed that C shall have his proportionate share of profits to date of retirement calculated on a "time" basis. Interest on capital is chargeable at the rate of 5 per cent per annum. The capitals are £6,000, £2,000, £1,200. Show Profit and Loss Appropriation Account, assuming that A and B continue to share profits and losses equally.

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

		9 mos. to 30 Sept., 19 .		3 mos to 31 Dec., 19 .			9 mos. to 30 Sept., 19..	3 mos. to 31 Dec., 19..
		£	£	£			£	£
To Interest on Capital—					By Net Profit .	b/d	(¾)3,600	(¼)1,200
A .	£225		75					
B .	75		25					
C .	45		Nil					
		345		100				
Balance:								
A: ⅓	£1,085		½ 550					
B: ⅓	1,085		½ 550					
C: ⅓	1,085		Nil					
		3,255		1,100				
		£3,600		£1,200			£3,600	£1,200

Illustration. A and B were partners sharing profits and losses—

(1) Interest on capital 5 per cent per annum on £4,200 and £1,200 respectively. No interest on drawings.

(2) Balance in the ratio of 3 : 2.

On 31st October, 19.., B died, and according to the partnership agreement his executors were entitled to—

(1) Capital at the last Balance Sheet subject to normal provisions for losses.

(2) Goodwill on the basis of profit-sharing ratio of the average *trading* profits of the last two completed years, and the last year or part thereof prior to death.

(3) Bad debts arising within one year from death on debts existing on the date of a partner's death to be considered as bad on the date of death.

Drawings of B to 31st December, 19.., were £500, of which £150 were since death, and drawn by his executor.

The profit for the year ended 31st December, 19.., was £940, *after* charging interest on capital and making all provision for known or likely losses.

The profits for the two years to 31st December prior to B's death were £1,200 and £600 respectively.

During the following year £300 balances in respect of debtors in the books at 31st October, 19.., were written off as irrecoverable, against which £35 previously written off was received.

Show the necessary accounts.

Ignore interest on the balance due to B's estate at date of death.

Dr. B CAPITAL *Cr.*

			£				£
19 Oct. 31	To Cash—Drawings		350	19 Jan. 1	By Balance	b/d	1,200
	,, Balance, transferred to Exors of B Loan Account		1,605	Oct 31	,, Interest on Capital		50
					,, Share of Profits		310
					,, ,, ,, Goodwill		395
			£1,955				£1,955

Dr. EXECUTORS OF B LOAN *Cr.*

			£				£
19 Dec. 31	To Cash		150	19 Oct 31	By Transfer from B's Capital Account		1,605
	,, Balance	c/d	1,455				
			£1,605				£1,605
				19 Jan 1	By Balance	b/d	1,455

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr*

			£				£
19 Oct. 31	To Interest on Capital — A: 5% on £4,200 for 10 mos £175 B: 5% on £1,200 for 10 mos 50		225	19 Dec 31	By Balance	b/d	1,200
	,, Balance— A: $\frac{3}{5}$ . . £465 B: $\frac{2}{5}$ . . 310		775				
	,, Balance	c/d	200				
			£1,200				£1,200
Dec. 31	To Interest on Capital— A: 5% on £4,200 for 2 mos.		35	Dec 31	By Balance	b/d	200
	,, Balance to A		165				
			£200				£200

Alternatively, this division may be ascertained in tabular form, and the Profit and Loss Appropriation Account presented in the ordinary way, thus—

		Proportion prior to B's death, i.e. 10 months	Proportion subsequent to B's death, i.e. 2 months	Total
	£	£	£	£
Net Profit for Year . . .	940			
Add Interest on Capitals on—				
£4,200 at 5% for one year . . . £210				
£1,200 at 5% for 10 months . . . 50				
	260			
Profit prior to Charging Interest	£1,200	(10/12) 1,000	(2/12) 200	1,200
Less Interest on Capital—				
£4,200 at 5% for 10 months (*a*)		(*a*) £175		A £210
do. for 2 months (*b*)			(*b*) 35	
£1,200 at 5% for 10 months (*c*)		(*c*) 50		B 50
		225		260
		775	165	940
Division of Net Profit . . .		A 3/5 £465	A £165	A £630
		B 2/5 310	B —	B 310
		£775	£165	£940

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

19..			£	19..			£
Dec. 31	To Interest on Capitals—			Dec. 31	By Balance . . .	b/d	1,200
	A . . .	£210					
	B . . .	50					
			260				
	,, Profit—						
	A . . .	£630					
	B . . .	310					
			940				
			£1,200				£1,200

Total profit for Goodwill purposes is £2,800, i.e. £1,200 plus £600 plus $\frac{10}{12}$ of £1,200. B's share of Goodwill = £2,800 × $\frac{12}{34}$ × $\frac{2}{5}$ = £395 [to nearest £].

Adjustments in Respect of Bad Debts. (1) It is a question of construction whether the bad debts recovered should be set off against the bad debts written off. It is purely a legal question, which is for the legal adviser to answer, but where the question is ambiguous it is advisable to take the fair view (that is, what appears to the student as such), adding a footnote that where EXPEDIENT legal opinion would be sought, and at the same time observing whether persons of ordinary intelligence and mind would, having regard to the amount at stake, incur such an expense; whilst reference might be made to ARBITRATION (again if the occasion warrants it). It is assumed here that the £35 is to be set off against the £300 written off, leaving bad debts referable to ten months ended 31st October, 19.., of £265; although the executors would doubtless require some evidence that the debts were in fact bad.

(2) The ten months' profits are, therefore, diminished by £265, of which B's share is two-fifths, that is, £106.

(3) As a result, the profits for the 34 months to 31st October,

19.., being diminished by £265, B's share of goodwill is reduced by £265 × $\frac{12}{34}$ × $\frac{2}{5}$ = £37 (to nearest £); hence B's executors will be debited with £106 and £37 and A's account credited, thus reducing the credit to the account of B's executors of £1,455 by £143 = £1,312. This may be shown by the following statement.

STATEMENT OF ACCOUNT OF EXECUTORS OF B WITH A

			£	£
19..				
Jan. 1	Credit balance of Capital Account . . .			1,200
Oct. 31	Interest on Capital			50
	Profits (to 31st October, 19..) . .	£1,000		
	Less Bad Debts (net) . . .	265		
			735	
	,, Interest on Capitals of A and B. . .		225	
	Divisible profits [i.e. £775 *less* £265] . . .		£510	
	$\frac{2}{5}$ thereof			204
	Goodwill:			
	Profits } last two completed years prior to B's		1,200	
	,, } death		600	
	,, 19.. (10 months, as above) . . .		735	
			£2,535	
	Average = $\frac{12}{34}$		£895	
	$\frac{2}{5}$ thereof			358
				1,812
	Less Cash (£350 plus £150)			500
	Credit balance of Executors of B Loan Account .			£1,312

Illustration. The following is the Trial Balance of X, Y and Z for the year ended 31st December, 19...

	£	£
Sundry Assets (excluding Stock) and Liabilities .	12,000	5,000
Capital and Drawings—		
X	600	3,000
Y	840	6,000
Z	960	4,000
General Expenses	1,160	
Gross Profit		3,200
Repairs	430	
Bad Debts	360	
Stock (closing valuation)	4,850	
	£21,200	£21,200

Profits were shared in the ratio of 2 : 1 : 1, after providing for interest on capital at 5 per cent per annum, annual salaries of £500 each to Y and Z, and interest on drawings at 6 per cent per annum.

Drawings were made monthly as follows: X £50, Y £70, and Z £80.

Z retired on the 30th September, 19 . and his drawings continued with the consent of X and Y to 31st December, 19 ..

You find that—

(1) Sundry assets at 30th September were worth £10,600 and depreciation is to be provided at £400 for the year.

(2) There was an opening Bad Debts Provision of £200, Bad Debts at 30th September were estimated at £150 and at 31st December nil. Bad Debts actually written off to 30th September were £490.

(3) Repairs were incurred of £370 prior to 30th September.

(4) Interest on Z's balance after 30th September, less drawings on account, to be at the rate of 4 per cent per annum till 31st December when settlement was to be made.

(5) X and Y continue to share profits as between themselves in the old ratio and Y's salary continues unchanged

(6) Goodwill, not in the books, is to be valued at 30th September at £4,000.

Show– (i) Profit and Loss Account for the year to 31st December, 19 , (ii) Balance Sheet at that date and (iii) Z's account showing the final balance due to him Work to the nearest £ and ignore tax.

Dr PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER 19 *Cr*

	£	£			£
To General Expenses[1]		1,160	By Gross Profit b/d		3,200
Balance c/d		2 040			
		£3 [illegible]00			£3,200
	(1) (9 mos.)	(2) (3 mos.)		(1) (9 mos.)	(2) (3 mos.)
To Repairs	370	[illegible]0	By Balance b/d	1 530	510
Bad Debts	140		" Bad Debts recovered		80
Depreciation	300	100			
Loan Interest		42			
Net Profit c/d	420	388			
	£1 [illegible]	£590		£1 530	£590
To Interest on Capitals			By Net Profit b/d	420	388
X	113	2[illegible]	" Interest on Drawings –		
Y	225	67	X	10	1
Z	150		Y	14	2
" Salaries			Z	16	
Y	375	125	" Balance		
Z	375		X	389	
Balance			Y	194	
X		118	Z	195	
Y		59			
	£1 238	£391		£1 238	£391

[1] Alternatively, instead of apportioning the balance after taking into account all the items which are apportionable on a time basis, the whole account may be shown in two columns, starting with the individual items in the Trading Account If this method is adopted the Profit and Loss Account will begin thus—

	(1)	(2)		(1)	(2)
	£	£		£	£
To General Expenses, etc	870	290	By Gross Profit, etc	2 400	800

BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£		£	£
Sundry Liabilities	5,000	Sundry Assets	12,000	
Loan—Z	4,121	*Less* Depreciation (9 mos.)	300	
Capitals—				
X	1,783		11,700	
Y	5,392	Loss on Revaluation	1,100	
			10,600	
		Less Depreciation (3 mos.)	100	
				10,500
		Stock		4,850
		Current Accounts—		
		X	747	
		Y	199	
				946
	£16,296			£16,296

Dr. Z LOAN *Cr.*

	£		£
To Current Account	406	By Capital Account	4,725
,, Balance c/d	4,319		
	£4,725		£4,725
To Drawings	240	By Balance b/d	4,319
,, Interest thereon	1	,, Interest thereon	43
,, Balance c/d	4,121		
	£4,362		£4,362
		By Balance b/d	4,121

Notes. (1) Interest on Drawings (in the absence of exact dates of withdrawals) are taken at an average due date of 4½ and 1½ months respectively.

(2) Assumed that X and Y calculate interest on capital on the revised capitals after the retirement of Z, and not for the whole year on the capitals at 1st January, 19...

(3)

Dr. BAD DEBTS *Cr.*

	£		£
To Bad Debts written off	490	By Opening Provision b/d	200
,, Provision, 30th September	150	,, P. and L. Account (9 mos. to 30th September)	440
	£640		£640
To Bad Debts written off	70	By Provision b/d	150
,, P. & L. Account (3 mos. to 31st Dec.)	80		
	£150		£150

(4)

Dr. CAPITALS *Cr.*

	X	Y	Z		X	Y	Z
	£	£	£		£	£	£
To Loss on Sundry Assets	550	275	275	By Balance b/d	3,000	6,000	4,000
,, Goodwill (2 : 1)	667	333	—	,, Goodwill (¼)	—	—	1,000
,, Transfer to Loan	—	—	4,725				
,, Balances c/d	1,783	5,392	—				
	£3,000	£6,000	£5,000		£3,000	£6,000	£5,000
				By Balances b/d	1,783	5,392	—

Dr. CURRENT ACCOUNTS *Cr.*

	X	Y	Z		X	Y	Z
	£	£	£		£	£	£
To Drawings (9 mos.)	450	630	720	By Salaries	—	375	375
„ Interest thereon	10	14	16	„ Interest on Capital	113	225	150
„ Loss (to 30th Sept.)	389	194	195	„ Transfer to Loan Account	—	—	406
				„ Balances c/d	736	238	—
	£849	£838	£931		£849	£838	£931
To Balances b/d	736	238	—	By Salary	—	125	—
„ Drawings (3 mos.)	150	210	—	„ Interest on Capital	22	67	—
„ Interest thereon	1	2	—	„ Profit (to 31st Dec.)	118	59	—
				„ Balances c/d	747	199	—
	£887	£450			£887	£450	
To Balances b/d	747	199					

Retired Partner's Balance as Loan. Upon the retirement or death of a partner, arrangements are frequently concluded whereby the final amount due to the ex-partner shall be paid by instalments, or even retained in the business in the form of a permanent loan. In either case, the agreement usually provides for interest to be paid either at a flat rate per cent, e.g. 6 per cent; or at a rate of interest varying with profits, e.g. 8 per cent of the net profits, or a rateable proportion of profits calculated by taking the ratio of the loan to the capitals and loans of all the partners; or both methods may be employed. However ascertained, the amount of loan interest is debited to the Profit and Loss Account of the firm and credited to the account of the ex-partner. There will be a deduction from such loan interest at the current rate of income tax. (See Chapter XXI.)

It is necessary in order to ascertain the amount due to the ex-partner to transfer to his Loan Account ALL his interest in the firm, so that the account will contain all or some of the following items according to the particular circumstances, e.g.

Dr. Y LOAN *Cr.*

19..			£	19..			£
Dec. 31	To Drawings			Dec. 31	By Balance of Capital		
	„ Interest on Drawings				„ Share of Goodwill		
	„ Balance				„ Profit[1] on Revaluation of Assets and Liabilities		
					„ Profits[1] to date of Retirement		
					„ Advance Account		
					„ Current[2] Account		
					„ Salary[2] Account		
					„ Interest on Capital		
					„ Interest on Advance		
					„ Interest[2] on Current Account		
					„ Reserves written back		

[1] If losses these entries will be debits.
[2] Debits if overdrawn.

Illustration. On 1st January, 1951, X retires from a firm, and the remaining partners agree to give him 5 per cent interest on the balance due to him, and to discharge the debt and interest in three equal instalments. The amount due on 1st January, 1951, is £720.

Dr. X LOAN *Cr.*

Date			£	s.	d.	Date			£	s.	d.
1951 Dec. 31	To Cash and Income Tax		264	7	9	1951 Jan. 1	By Transfer from Capital Account		720	0	0
	,, Balance	c/d	491	12	3	Dec. 31	,, Interest at 5% per annum		36	0	0
			£756	0	0				£756	0	0
1952 Dec. 31	To Cash and Income Tax		264	7	9	1952 Jan. 1	By Balance	b/d	491	12	3
	,, Balance	c/d	251	16	1	Dec. 31	,, Interest at 5% per annum		24	11	7
			£516	3	10				£516	3	10
1953 Dec. 31	To Cash and Income Tax		264	7	9	1953 Jan. 1	By Balance	b/d	251	16	1
						Dec. 31	,, Interest at 5% per annum		12	11	8
			£264	7	9				£264	7	9

Payment to Retired Partner Based Upon Profits. After agreeing the amount due to the retired partner, the terms of repayment must be agreed upon, having regard to the financial position of all the parties. In many cases the precise amount of repayment is made to depend upon the ability to pay as measured by the profits in succeeding periods, e.g. the repayment in the first year may be 20 per cent of the profits, in the second 25 per cent, and so on, always remembering that such a payment is not a SHARE OF PROFITS, but merely an instalment of a debt, such instalment being dependent upon the relative prosperity of the firm; moreover, it should be remembered that the retired partner can at the most receive the amount of his debt with interest (except in the case where he applies and gets leave of the Court to have a share of profits in lieu of interest).

Illustration. Upon dissolution, the final adjusted balance due to X is £2,000. It is agreed that the *total* payment to him for the first year after dissolution shall be 20 per cent of the profits before adjusting interest on capital at 5 per cent per annum. The remaining partners, Y and Z, share profits equally, their capitals being £4,000 and £1,500 respectively. Drawings for the year: Y £600, Z £400.

Interest is payable to the retired partner at 6 per cent per annum. Show Appropriation Account, Capital Accounts, and X's Loan Account.

The profits for the year after dissolution prior to charging interest on loan or interest on capital were £3,195. Ignore tax.

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

To X—Interest on Loan		£ 120	By Balance	b/d	£ 3,195
„ Interest on Capital—					
Y.	£200				
Z.	75				
		275			
„ Balance—					
Y. ½	£1,400				
Z. ½	1,400				
		2,800			
		£3,195			£3,195

Dr. CAPITALS *Cr.*

		Y	Z			Y	Z
To Drawings		£ 600	£ 400	By Balances	b/d	£ 4,000	£ 1,500
„ Balances	c/d	5,000	2,575	„ Interest on Capital		200	75
				„ Profits		1,400	1,400
		£5,600	£2,975			£5,600	£2,975
				By Balances	b/d	5,000	2,575

Dr X LOAN *Cr.*

To Cash		£ 615	By Balance	b/d	£ 2,000
„ Balance	c/d	1,505	„ Interest thereon for one year at 6% per annum		120
		£2,120			£2,120
			By Balance	b/d	1,505

Note 1. When the figure of instalment has been computed the ordinary entry is made; debit X, credit cash. The amount of £615 is *not* a share of profits due to X, and therefore must not be credited to him.

Note 2. The item of £120 is not an appropriation; it is interest on a debt and a charge against profits. The profits of the firm are thus £3,195 *less* £120 equals £3,075; 20 per cent of this figure merely measures the quantum of the cash to be applied in reduction of debt and interest due to X at the end of the year. The question definitely states 20 per cent of the profits before adjusting *Interest on Capital.* Had it stated 20 per cent of the profits before adjusting INTEREST, the figure would be 20 per cent of £3,195.

Illustration. A, B, and C are partners sharing profits and losses equally, and having £2,000 each as capital. Their accounts are always prepared on a cash basis.

A retires on 31st December, 1952, and is to receive 5 per cent per annum on the outstanding balance on his Loan Account. It is provided, *inter alia,* in the agreement of dissolution that A's share of goodwill is to be computed at[1] one-half of the cash profits of the last two years. A is to have the sum of £500 immediately; £500 plus interest at the rate of 5 per cent per annum on the outstanding balance due to him, together with a sum representing 35

[1] [*Observe that the question does NOT state "average of the last two years."*]

per cent of the net profits of the business calculated on an *earned basis* at the end of 1953. The profits computed on a cash basis were: 1951 £1,500, 1952 £2,100. Fees received 1953, £4,500. Fees outstanding at 31st December, 1952, were £1,500; those at 31st December, 1953, £465. Ignore income tax and uncompleted work. Expenses for the year ended 31st December, 1953, were £1,300. There were no expenses outstanding at either 31st December, 1952, or at 31st December, 1953.

Show Profit and Loss Account for the year ended, and A's account as at 31st December, 1953.

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 1953

Dr. *Cr.*

			£				£
	To Expenses . . .		1,300		By Fees Received .		4,500
	,, Interest on Loan: A—5% on £3,300. .		165				
	,, Balance—						
	B ½ . £1,517 10 0						
	C ½ . 1,517 10 0		3,035				
			£4,500				£4,500

A LOAN

Dr. *Cr.*

			£				£
1953 Jan. 1	To Cash		500	1953 Jan. 1	By Transfer from Capital Account . .		3,800
Dec. 31	,, ,, (See note (2) below)		1,365	Dec. 31	,, Interest . . .		165
	,, Balance . . .	c/d	2,100				
			£3,965				£3,965
				1954 Jan. 1	By Balance . .	b/d	2,100

A CAPITAL

Dr. *Cr.*

			£				£
1953 Jan. 1	To Transfer to Loan Account. .		3,800	1952 Dec. 31	By Balance . . .		2,000
					,, ⅓ Share of Goodwill (See note (1) below)		1,800
			£3,800				£3,800

(1) Computation of Goodwill:

$\frac{1}{2} \times (£1,500 + £2,100) = £1,800$

Total Goodwill is therefore £5,400, hence it is correct to describe the credit to A as $\frac{1}{3}$ share of Goodwill.

(2) Computation of Cash payable:

£500 + £165[1] + 35% of "EARNED" profits £2,000 (See note (3) on next page).

= £665 + £700

= £1,365

[1] Unlike Interest on Capital, which is merely internal arrangement of profits, Interest on Loan will, as seen, suffer deduction of income tax.

(3) **Computation of "Earned" Profits:**

	£	£
Fees Received	4,500	
Less Fees Outstanding at 31st Dec., 1952	1,500	
		3,000
Add Fees Outstanding at 31st Dec., 1953		465
Total "Earned" Fees		3,465
Less Expenses	1,300	
Interest on Loan	165	
		1,465
Net "Earned" Profit		£2,000

It is assumed that (*a*) there is no interest on capital, (*b*) B and C continue to share profits equally on a cash basis, (*c*) all the payments ARE made on the due dates.

It is noted that (*a*) no account is taken of depreciation or stocks (e.g. stationery, books, etc.), (*b*) no provision is mentioned for the payment to B in the second year, this probably being included in the term "*inter alia*."

No mention is made of the existence of Current and/or Drawings Accounts which would, especially considering the equal capitals in a round sum, be in the books; nor of any share of the profits to date of dissolution, which further strengthens the assumption as to the existence of Current and/or Drawings Accounts.

The statement in the question "such sum representing 35 per cent of the net profits" merely indicates that B's Loan Account will be reduced by a PAYMENT of such a sum. The amount of the payment depends upon the success or otherwise of the business in 1953, but the statement does *not* mean that A is entitled to 35 per cent of the PROFITS. Had the words "such a sum representing" been omitted the question might be capable of this interpretation, although hardly likely, since A retired obtains a greater share than if he were a partner, as well as interest, quite apart from the fact that he has been credited with his share of goodwill.

Share of Profits in Lieu of Goodwill. As an alternative to a payment for goodwill, a retiring partner may elect to receive a proportion of profits. It is a matter of agreement between the parties as to what constitutes profits, whether, for instance, salaries and interest on capital should be charged in the Profit and Loss Account before ascertainment of profit. In the absence of agreement it would appear that as between the remaining partners on the one hand, and the retired partner on the other, the proportion of profits due to the latter is a CHARGE and, consequently, it should be chargeable BEFORE the ascertainment of such figure.

Illustration. A is to have one-ninth of the profits of the firm for one year after his retirement, and the profits before A's share is ascertained are £1,800. Show the proportion due to A.

The proportion due to A is—

(1) $\frac{1}{9} \times$ £1,800 = £200, *or*
(2) $\frac{1}{10} \times$ £1,800 = £180 [i.e. $\frac{1}{9}$ of the remaining profits, £1,620]

Illustration. A partnership consisting of four partners A, B, C, and D is dissolved, A retiring, the others continuing; the profit-sharing ratio was: 1 : 3 : 3 : 1. After A's retirement B, C, and D continue to share profits in the same ratio as before. The trading profits for the first year after dissolution are £1,200. Show the manner of dealing with the trading profits, assuming that in lieu of goodwill A is to receive one-fifth share of profits.

The following are the divisions (to nearest £)—

If A's share is to be considered as a *charge*, the following is the division between B, C, D.

	£	£
Profits	1,200	
Less A, $\frac{1}{6}$ . . .	200	
Balance divisible . .		1,000
B, $\frac{3}{7}$ . . .	429	
C, $\frac{3}{7}$ . . .	428	
D, $\frac{1}{7}$ . . .	143	
		1,000

If A's share is to be considered as an *appropriation*, i.e. one-fifth of £1,200, the following is the division between B, C, D.

	£	£
Profits	1,200	
Less A, $\frac{1}{5}$ . . .	240	
Balance divisible . .		960
B, $\frac{3}{7}$ . . .	412	
C, $\frac{3}{7}$ . . .	411	
D, $\frac{1}{7}$ . . .	137	
		960

Elliott *v*. Elliott. In normal circumstances the amount due to a retired partner is a debt payable by the firm. Where, however, as in *Elliott* v. *Elliott*, the remaining partners have agreed personally to buy the retired partner's share, the amount is no longer a *firm* debt, but one due individually by the remaining partners in the agreed ratio. Failing agreement on this latter point, the liability should be divided in profit and loss sharing ratio. Thus, after the *total* amount due to the deceased or retired partner has been credited to his account, it should be transferred to the Capital Accounts of the remaining partners in their profit and loss sharing or other agreed ratio, and if cash is paid to the ex-partner out of firm's money, it will be debited to the Current Account or Drawings Account of the partner on whose behalf the money is paid. The principle behind this is that the "buying out" partners are personally liable to the retired partner, and therefore the *firm* is absolved from liability, and so the amount due to the retiring partner must be eliminated from the firm's books. The retired partner's or deceased partner's representative must look for payment, not to the *firm*, but to the individual partners in their *private* capacity.

Illustration. Q, S, and O are in partnership, sharing profits and losses 3 : 2 : 1, and Q retires as from 31st December, 19.., when their Balance Sheet is as follows—

Q, S, AND O BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£	£			£
Capitals—			Sundry Assets . .		15,000
Q . . .	8,000				
S . . .	5,000				
O . . .	2,000				
		15,000			
	£	15,000		£	15,000

Show entries applying the rule in *Elliott* v. *Elliott*, assuming that S and O share profits in the ratio of 2 : 1. In addition, the goodwill (not in the books) is worth £12,000.

The entries in accordance with *Elliott* v. *Elliott* are as under—

JOURNAL

			£	£
19.. Dec. 31	Goodwill . . . . . *Dr.*		12,000	
	To Q Capital			6,000
	,, S ,, ...			4,000
	,, O ,, ...			2,000
	Being division of Goodwill in profit-sharing ratio.			
	Q Capital . . . . . *Dr.*		14,000	
	To S Capital [1] . . .			9,333
	,, O ,, [1]			4,667
	Being transfer of Q's balance on his retirement.			

Dr. Q CAPITAL *Cr.*

			£				£
19 Dec. 31	To Transfers—			19 . Dec. 31	By Balance . . .	b/d	8,000
	S Capital		9,333		,, Share of Goodwill .		6,000
	O ,, ...		4,667				
		£	14,000			£	14,000

S AND O BALANCE SHEET AS AT 1ST JANUARY, 19..

	£		£
Capitals—		Sundry Assets . . .	15,000
S	18,333	Goodwill . . .	12,000
O	8,667		
	£27,000		£27,000

[1] To nearest £

If the goodwill is to be written out again, it will be treated as a loss to the new firm, and cannot alter the amount due to the retiring or deceased partner, so that the transfer required in *Elliott* v. *Elliott* is unaffected. The entries required will be—

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19..			£	£
Jan. 1	S Capital $\frac{2}{3}$ . . . . . . *Dr.*		8,000	
	O ,, $\frac{1}{3}$ . . . . . . *Dr.*		4,000	
	To Goodwill			12,000
	Being Goodwill written out of the books.			

S AND O BALANCE SHEET AS AT 1ST JANUARY, 19..

	£		£
Capitals—		Sundry Assets . . .	15,000
S	10,333		
O	4,667		
	£15,000		£15,000

Provision for Payment to a Retiring Partner. Where a firm wishes to be in a position to make prompt payment of the amount due to a retiring partner, or in the event of death to his estate, an amount of money is set aside and invested in Stock Exchange securities, or in the form of an assurance policy.

The investments will be made and entered in the manner of acquiring any other asset, whilst the dividends will usually be reinvested; and when the need for the cash arises the investments will be realized, any profit or loss thereon being credited or debited to Profit and Loss Account.

With regard to the policy, there are two methods used.

(1) To consider the premium as an ordinary business expense, that is, by debiting Profit and Loss Account or Drawings or Current Accounts in profit and loss ratio, and crediting cash, so that NO ASSET appears in the books of the partnership; when the policy becomes payable, normally by the decease of one of the partners, the amount due from the insurance company is treated as a profit. The division of such "profit" must be made in profit sharing ratio (always subject to a contrary agreement). Where there have been CHANGES in the CONSTITUTION, the method employed is to prepare a schedule showing the "build up" of the amount during each period measured by the changes, whether of profit sharing or of personnel. In the last period there will very probably be a substantial surplus over the estimated value at the date of the last change because of the maturity of the policy. It is, moreover, a frequent practice to agree and pay to an outgoing partner the estimated value of the policy at the date of retirement, whilst if the partner retiring is BOUGHT out the settlement will almost invariably include the estimated value of the policy. In these circumstances the

continuing partners who bore the charge—seeing that no asset appears in the books—will be credited, when the policy matures, with the amount in due proportion previously credited to the retiring partner and debited back to them.

(2) To treat the payment of the premium upon the policy as an INVESTMENT, either with or without an annual revaluation.

It should be realized that the policy is an ASSET of the **Firm.** Usually there is a policy on the life of EACH partner, unless a joint or survivorship policy is taken out in respect of the joint lives of the partners.

Illustration. Q, S, and O are in partnership as and from the 1st January, 1951, sharing profits and losses 3 : 2 : 1. They took out a survivorship assurance policy for £6,000, upon which the annual premium is £300 payable 1st February yearly. S dies on 31st December, 1953, the insurance company in due course paying the amount due. The firm closes its books on 31st December of each year. Show Journal entries.

Method 1. JOURNAL

			£	£
1951 Feb 1	Profit and Loss Account[1] . . Dr.		300	
	To Cash			300
	Being annual premium on survivorship policy.			
1952 Feb 1	Profit and Loss Account[1] . . Dr.		300	
	To Cash			300
	Being annual premium on survivorship policy.			
1953 Feb 1	Profit and Loss Account[1] . . Dr.		300	
	To Cash			300
	Being annual premium on survivorship policy.			
	(*Upon the receipt of the policy money*)			
Dec. 31	Cash . . . . . . Dr.		6,000	
	To Capital—			
	Q			3,000
	S			2,000
	O			1,000
	Being receipt of policy money on the death of S apportioned amongst the partners as per partnership agreement			

Method 2.

Assume that the surrender values of the policy dealt with in the foregoing example were—

	£
31st December, 1951 . . .	Nil
31st December, 1952 . . .	200

[1] Or Drawings Account in the ratio of 3 : 2 : 1.

Show Policy Account.

The Policy Account for the three years will be as below—

Dr. POLICY *Cr.*

			£				£
1951 Feb. 1	To Cash: Premium		300	1951 Dec. 31	By Surrender Value		Nil
					,, Profit and Loss Account		300
1952 Feb. 1	To Cash: Premium		300	1952 Dec. 31	By Surrender Value	c/d	200
					,, Profit and Loss Account		100
			£300				£300
1953 Jan. 1	To Surrender Value	b/d	200	1953 Dec. 31	By Cash: Policy Money		6,000
Feb. 1	,, Cash: Premium		300				
Dec. 31	,, Capital— Q . . £2,750[1]; S . . 1,833; O . . 917		5,500				
			£6,000				£6,000

Assignment of Life Policies. Although not confined to Partnership Accounts, it will be convenient to deal here with the assignment of a life policy in discharge of a debt, in order that the broad outlines of the treatment of life policy may be dealt with under one heading.

It frequently happens that a debtor assigns his life policy to a creditor in satisfaction of his liability, in which case the assignee must pay the premiums. In taking over the policy the creditor will credit the debtor only with its surrender value, as that is the value which is available on surrender, the assignee being in no better position than the assignor.

If there remains a debit balance on the debtor's account after the credit given for the surrender value of the policy, it will be written off to Bad Debts Account.

In the creditor's book there are alternative treatments in respect of the policy and the premiums, viz.—

Upon receipt of policy—

(1) (*a*) Debit Policy Account with surrender value.
Credit Debtor with surrender value
(*b*) Debit Bad Debts Account with loss.
Credit Debtor.

(2) Debit Policy Account with investment value.
Credit Debtor with surrender value, and write off balance as in (1) (*b*) above.
Credit (*a*) Policy Reserve Account with the excess of investment over surrender value, or
(*b*) Bad Debts Account.

(3) See (*d*) page 669.

[1] To nearest £.

Treatment of Premiums. The premiums paid may be dealt with as shown below.

(*a*) Debit Profit and Loss Account. Credit Cash.

(*b*) Debit Capital, Drawings, Current or Reserve Account in profit and loss ratios. Credit Cash.

(*c*) Debit Life Policy Account. Credit Cash.

(*d*) Debit Life Policy Account with the *nominal* amount of the policy and credit Life Policy Reserve Account (on taking out or receiving the policy); debit the Life Policy Reserve Account and credit Cash upon the payment of premiums.

(*e*) As in (*c*) or (*d*), and debit the Life Policy Account (*c*) or Life Policy Reserve Account (*d*) with loading for interest, and credit Profit and Loss Account.

(*f*) Each year bring down the balance (representing the investment or surrender value) either in the Life Policy Account or by adjustment of the Reserve, writing off the difference as in (*a*) or (*b*).

(*g*) Debit premiums to the Life Policy Account and revise the value thereof through the Life Policy Reserve Account, the value in question being investment or surrender value.[1]

If the policy is to be maintained at investment value, interest may be debited thereto and credited to Profit and Loss Account; but if it is to be maintained at surrender value, the latter value will be credited in the Policy Account and brought down, the difference being transferred to the debit of Profit and Loss Account, as the increase in surrender value will be *less* than the premium paid. (See illustration, page 668.)

Upon receipt of policy money—

Debit Cash. Credit Policy Account.
Debit Policy Account. Credit Profit and Loss Account.

Illustration. Fraser, owing Jones £1,000, agrees to assign his life policy to him in complete discharge of the debt. The assignment is made on 1st July, 1952, the policy being for £1,750. The premium is £60, payable yearly on 1st September.

On 15th January, 1954, Fraser dies, the policy money being paid to Jones on 31st January, 1954.

The surrender values are (1) at the date of assignment, £320; (2) at 31st October, 1952, £358; and (3) at 31st October, 1953, £398.

Jones prepares his accounts annually at 31st October.

Assuming that Jones desires to keep the policy at its surrender value, show the necessary Ledger Accounts in his books.

Dr. FRASER *Cr.*

			£			£
1952 July 1	To Balance	b/d	1,000	1952 July 1	By Life Policy Account *re* Fraser—Policy taken over in discharge, Surrender Value	320
					,, Bad Debts Account	680
			£1,000			£1,000

[1] Companies exist which deal with policies by way of purchase and sale. Their price will be generally higher than surrender and lower than investment value.

Life Policy Account No. ....
re Fraser

Dr.				*Cr.*			
1952			£	1952			£
July 1	To Fraser—Policy taken over, Surrender Value		320	Oct. 31	By Profit and Loss Account . . .		22
Sept. 1	,, Cash—Yearly Premium		60		,, Balance . . .	c/d	358
			£380				£380
Nov. 1	To Balance . . .	b/d	358	1953 Oct. 31	By Profit and Loss Account . . .		20
1953 Sept. 1	,, Cash—Yearly Premium		60		,, Balance . . .	c/d	398
			£418				£418
Nov. 1	To Balance . . .	b/d	398	1954 Jan 31	By Cash . . .		1,750
1954 Jan. 15	,, Profit and Loss Account . . .		1,352				
			£1,750				£1,750

[Alternatively, the same result may be arrived at by showing the Policy at its *nominal* value and opening a Policy Reserve Account thus (dealing only with the first year)]—

Life Policy Account
re Fraser

Dr.				*Cr.*			
1952			£				
July 1	To Fraser—Policy taken over, Surrender Value		320				
	,, Life Policy Reserve .		1,430				
			1,750				

Life Policy Reserve
re Fraser

Dr.				*Cr.*			
1952			£	1952			£
Sept. 1	To Cash—Yearly Premium		60	July 1	By Life Policy Account—*re* Fraser . .		1,430
Oct. 31	,, Balance[1] . . .	c/d	1,392	Oct. 31	,, Profit and Loss Account . . .		22
			£1,452				£1,452
				Nov. 1	By Balance . . .	b/d	1,392

Ignoring interest, there is a profit of £630 to Jones, arrived at as follows—

	£	£
Profit on Life Policy		1,352
Less amounts written off—		
Year ended 31st October, 1952	22	
,, ,, 1953	20	
		42
Balance.		1,310
Less Bad Debt written off		680
Profit		£630

[1] Nominal value of policy, £1,750, less surrender value of policy, £358.

This may be reconciled with the cash receipts as follows—

	£	£
Cash received on 31st January, 1954		1.750
Less Premium paid on 1st September, 1952	60	
,, ,, ,, 1953	60	
	—	120
Net Cash received		1,630
Less Debt due by Fraser		1,000
Profit		£630

Illustration. On 1st July, 1952, the total surrender value of the life policies of £3,500 of the partnership is £1,500. The annual premiums of £100 paid to date are £2,000. Show in columnar form the accounts, assuming that the premiums are paid on 1st November, 1952, and that the surrender value on 30th June, 1953, is £1,575, using Methods (*d*) and (*g*), and adjusting as required by paragraph (*f*). The accounts appear on page 672.

If the partners have taken out a joint policy, the account will be closed upon the maturity of the policy, any profit being credited to Profit and Loss Account, or Capital Accounts in profit ratios.

Where *separate* policies exist, the one which has matured will be similarly dealt with and, in addition, a revaluation of the other policies will be necessitated.

Capitals of Remaining Partners to be Adjusted to New Profit-sharing Ratio. The treatment of accounts where a partner is required to bring in cash so that capitals are in profit-sharing ratios has been dealt with on page 633, and the same principle applies on a retirement or death of a partner.

Illustration. The following is the Balance Sheet of A, B, and C, sharing profits and losses in the ratio of 2 : 2 : 1.

A, B, AND C BALANCE SHEET

	£	£		£	£
Capitals—			Sundry Assets (including Goodwill)		5,500
A	2,000		Cash		500
B	3,000				
C	1,000				
		6,000			
		£6,000			£6,000

A retires and is to be paid in cash, B and C agreeing to provide the necessary funds, and at the same time to increase the cash balance to £800, the contributions to be such as to leave their capitals in their profit-sharing ratio which is to be unchanged.

METHOD (d)

DEBIT SIDE — LIFE POLICY				DEBIT SIDE — LIFE POLICY RESERVE				CREDIT SIDE — LIFE POLICY RESERVE			
			£				£				£
1952 July 1	To Balance .	b/d (a)	3,500	1952 Nov. 1	To Cash: Premium		100	1952 July 1	By Balance .	b/d	2,000
				1953 June 30	,, Balance .	c/d	1,925	1953 June 30	,, Profit & Loss Account		25
							£2,025				£2,025
								July 1	By Balance .	(b) b/d	1,925

METHOD (g)

DEBIT SIDE — LIFE POLICY				CREDIT SIDE — LIFE POLICY RESERVE			
			£				£
1952 July 1	To Balance .	b/d	2,000	1952 July 1	By Balance .	b/d	500
Nov. 1	,, Cash: Premium		100	1953 June 30	,, Profit & Loss Account		25
		(c)	£2,100			(d)	£525

[$a - b$ = £1,575.] [$c - d$ = £1,575.]

		£	£
The amount of cash required is—			
Due to A		2,000	
Plus increase of cash balance		300	
			2,300
to which will be added the combined capitals of B and C			4,000
gives the total resultant capitals of B and C			£6,300

STATEMENT OF CAPITALS (B AND C)

	Total	B	C
	£	£	£
New Capitals	6,300	4,200	2,100
Old Capitals	4,000	3,000	1,000
Contributions	£2,300	£1,200	£1,100

BALANCE SHEET (after completing aforesaid arrangements)

	£	£		£	£
Capitals—			Sundry Assets		5,500
A Balance:			Cash		800
£2,000 – Cash £2,000	nil				
B Balance:					
£3,000 + Cash £1,200	4,200				
C Balance:					
£1,000 + Cash £1,100	2,100				
		6,300			
		£6,300			£6,300

Interest from Last Balance Sheet in Lieu of Profits. In order to avoid splitting of profits, the partnership agreement may provide that interest be paid in lieu of profits from the date of the last Balance Sheet to the date of death or retirement. The agreement should be carefully worded so that any dispute as to the amount on which the interest is to be paid (e.g. on Capital Account alone or Capital plus Current Account, etc.) will be avoided.

Illustration. A, B, and C are in partnership sharing profits 3 : 2 : 1. The partnership agreement provided that, on the death or retirement of a partner, the partner or his estate shall be entitled to 10 per cent per annum on his share of partnership assets from the date of the last Balance Sheet to the date of death, in lieu of profits. On 31st December, 1952, the date of the last Balance Sheet, the Capital Accounts stood as follows: A £6,000, B £5,000, C £3,000, and the Current Accounts as follows: A £1,000, B £1,200, C £600. B died on 30th June, 1953, and his share of goodwill, which was not included in the books, was valued at £2,000. The

amount payable to the executors of B would appear in his Loan Account, ignoring tax, as follows—

Dr. EXORS. OF B LOAN *Cr.*

1953			£	1953			£
June 30	To Balance . . .	c/d	8,610	Jan. 1	By Balance of Capital Account . .		5,000
				June 30	„ [1]Transfer from Current Account . .		1,200
					„ Share of Goodwill .		2,000
					„ Interest . . .	†	410
			£8,610				£8,610
				July 1	By Balance . . .	b/d	8,610

† £8,200 at 10% per annum for 6 months.

SECTION (E) RETIREMENT AND ADMISSION

The positions arising upon a partner's retirement and admission have been dealt with separately. It now remains to deal with the combined change: the retirement *and* admission taking place at the same time. It very frequently happens that when one partner retires another is admitted, the capital introduced by the new partner being utilized wholly or partly in discharge of the liability of the old firm to the retiring partner.

No departure from the principles enumerated is entailed, the question being more one of detail caused by the two "sets" of transactions.

Illustration. Q, S, and O, partners, share profits and losses in the ratio of 3 : 2 : 1. S retires on 31st December, 19.., and D is admitted a partner on the same date, the new ratio to be 4 : 4 : 3. The latter is required to bring into the firm so much capital as will make his share one-third of the total assets as revalued.

The following is the Balance Sheet of Q, S, and O—

BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£	£		£	£
Capitals—			Stock . . .		10,000
Q . . .	7,000		Debtors . . .	4,000	
S . . .	5,000		*Less* Bad Debts Provision . .	400	
O . . .	3,000				
		15,000			3,600
Reserve . . .		1,400	Cash . . .		2,800
	£	16,400		£	16,400

The partnership agreement gives certain directions as to the value of the assets to be taken for the purpose of dissolution, these

[1] In the event of any changes having taken place in the Current Account balance during the period between the last Balance Sheet and the date of death, the interest will have to be calculated in the form of an Account Current.

Dr. CAPITALS Cr.

			Q	S	O	D				Q	S	O	D
			£	£	£	£				£	£	£	£
19 . Dec 31	To Cash[1] .			7,200			19 . Dec 31	By Balances	b/d	7,000	5,000	3,000	
	,, Balances	c/d	10,300		4,100			,, Memorandum Revaluation Account		3,300	2,200	1,100	
		£	10,300	£7,200	£4,100				£	10,300	£7,200	£4,100	
19 . Jan 1	To Memorandum Revaluation Account		2,400		2,400	1,800	19 . Jan 1	By Balances	b/d	10,300		4,100	
	,, Balances	c/d	7,900		1,700	5,400		,, Cash .					7,200
		£	10,300		£4,100	£7,200			£	10,300		£4,100	£7,200
								By Balances	b/d	7,900		1,700	5,400

[1] The balance of capital is usually transferred to Partner's Loan Account and cash debited thereto

Dr. *Memorandum* REVALUATION ACCOUNT *Cr.*

Date	Particulars		£	£	Date	Particulars		£	£
19.. Dec. 31	To Decrease in Asset—				19 Dec 31	By Increase in Assets—			
	Stock	c/d		400		Debtors (Bad Debts Provision)	c/d	200	
	,, Profit on Revaluation—					Goodwill	c/d	5,400	
	Q $\frac{1}{2}$		3,300						5,600
	S $\frac{1}{3}$		2,200			,, Decrease in Liability—Reserve	c/d		1,400
	O $\frac{1}{6}$		1,100						
				6,600					
				£7,000					£7,000
19. Jan. 1	To Reversal of Items	b d		7,000	19 Jan 1	By Reversal of Item	b/d		400
						,, Balance—			
						Q $\frac{4}{11}$		2,400	
						O $\frac{4}{11}$		2,400	
						D $\frac{3}{11}$		1,800	
									6,600
				£7,000					£7,000

being: stock, £9,600; sundry debtors, £3,800; and goodwill, £5,400. D agrees to his admission being based upon these valuations.

Show the Capital Accounts of the partners, the revised Balance Sheet, and a Memorandum Revaluation Account.

If the adjustments are not to be shown permanently in the books, the above question naturally falls into two main parts, viz.—

(1) The adjustment of asset values upon the retirement of S.

(2) The admission of D and the book readjustment of asset values.

BALANCE SHEET AS AT 1ST JANUARY, 19..

	£	£		£	£
Capitals—			Stock . . .		10,000
Q . . .	7,900		Debtors . . .	4,000	
O . . .	1,700		*Less* Bad Debts Provision .	400	
D . . .	5,400				3,600
		15,000	Cash [£2,800 + £7,200 − £7,200] .		2,800
Reserve . . .		1,400			
	£	16,400		£	16,400

It will be seen that the capital to be introduced by D is based upon the combined capitals of Q and O before the elimination of the adjustments from the books, i.e. $\frac{1}{2} \times$ (£10,300 + £4,100) = £7,200.

If it were decided, *after* the reversal has been made, to bring the adjustments permanently into the books, there would be a book profit of £6,600 which would be credited to Q £2,400: O £2,400 and D £1,800, thus eliminating the reversing entries of 1st January, 19.., and restoring the true position.

The TRUE position at 1st January, 19.., is—

	£	£
Capital Accounts as per books . . .		15,000
Add Net Undisclosed Assets, i.e.—		
Debtors, Goodwill and Reserve . .	7,000	
Less Stock Depreciation . .	400	
		6,600
		£21,600

The Capital Accounts would be revised on entering the undisclosed figures, and the table given at top of page 678 shows the position.

This is the precise result that would have been obtained by a "straight" entry of the net assets and a credit to the old partners.

Capitals

	Q	O	D
	£	£	£
Balances per Balance Sheet . .	7,900	1,700	5,400
Add "Profit," £6,600 . .	$\frac{4}{11}$ 2,400	$\frac{4}{11}$ 2,400	$\frac{3}{11}$ 1,800
True Capitals . .	£10,300	£4,100	[1] £7,200

Illustration. A, B, and C are partners with capitals of £2,000, £2,500, and £1,800 respectively. On the retirement of A and the introduction of D, goodwill (which is not in the books) is valued at £750, other undisclosed assets at £600. The profits were shared in the proportion of 2 : 2 : 1, the new firm to divide profits equally. D is to introduce cash £1,000. The book values of the assets are to remain unchanged. Show Capital Accounts. See page 679.

Illustration. At 31st December, 1951, when C was admitted a partner on a one-sixth basis the undisclosed assets not brought into account were an insurance policy £400, and investments £600. A and B had previously been equal partners. On 31st December, 1952, D was admitted as a partner, the new ratios being 10 : 10 : 4 : 3. On 31st December, 1953, A died and the policy fell in for £700 and the investments were sold for £690. Goodwill is to be adjusted outside the business. The estimated values of insurance policy and investments as at 31st December, 1952, were £600 and £520—the insurance premiums being charged and the dividends credited to Profit and Loss Account in the ordinary way. Show the division of the proceeds.

	Insurance Policy	Increase	Investments	Increase or Decrease	Net Increase or Decrease	A	B	C	D
	£	£	£	£	£	£	£	£	£
31st Dec., 1951	400		600		1,000	500	500		
1952	600	+ 200	520	[2] − 80	120	50	50	20	
1953	700	+ 100	690	+ 170	270	100	100	40	30
					£1,390	£650	£650	£60	£30

When entered into the books cash will be debited with £1,390, and the Capital Accounts credited in the above proportions.

If A had *retired* on 31st December, 1953, the values of the undisclosed assets would be dealt with on the lines already explained. Further, if A's share is purchased there will be a transfer from A's account (after having given him credit on the revaluation) by

[1] $\frac{1}{3}$ of total Capital.

[2] Assumed A and B continue to share profits equally as between themselves in 1952.

Dr. CAPITALS *Cr.*

		A	B	C	D			A	B	C	D
		£	£	£	£			£	£	£	£
To Balances . . .	c/d	2,540	3,040	2,070		By Balances . . .	b/d	2,000	2,500	1,800	
						,, Revaluation of Assets	c/d	240	240	120	
						,, Goodwill . . .	c/d	300	300	150	
		£2,540	£3,040	£2,070				£2,540	£3,040	£2,070	
To Revaluation of Assets .	b/d		200	200	200	By Balances [*see note*] .	b/d	[1] 2,540	[1] 3,040	[1] 2,070	
,, Goodwill . . .	b/d		250	250	250	,, Cash . . .					[1] 1,000
,, Balances . . .	c/d		[2] 2,590	[2] 1,620	[2] 550						
,, Loan Account . .		2,540									
		£2,540	£3,040	£2,070	£1,000			£2,540	£3,040	£2,070	£1,000
						By Balances . . .	b/d		2,590	1,620	550

[1] True Capitals. [2] "Book" Capitals.

Note—If the partners decided to adjust their capitals to profit sharing ratios D would bring in a further £1,036 13s. 4d., B and C respectively withdrawing £1,003 6s. 8d. and £33 6s. 8d., leaving all the partners with £2,036 13s. 4d. each.

debiting his account and crediting the continuing partners, the latter being personally liable to A.

Illustration. A, B, and C are partners. The business is divided into £30 shares owned as follows: A, 60; B, 15; C, 25. The goodwill value of a share is £100, but no amount for goodwill stands in the books. The capital accounts are: A, £1,800; B, £450; and C, £750.

On 1st January, 19.., D is admitted as a partner on terms that

(i) A is to sell 10 shares to B.
(ii) A is to sell 10 shares to D.
(iii) C is to sell 5 shares to D.

The total capital is to remain undisturbed and individual capitals are to be adjusted according to these shares. D is permitted to pay half of the amount due immediately, the balance due to be treated as a loan bearing interest at 10 per cent per annum, such amount being transferred proportionately to the credit of the selling partners. There is to be no other selling adjustment. Any surplus on D's Current Account at the end of a year is to be applied in payment of the loans by A and C.

Drawings are to be £5 per share per month. The profit for the year to 31st December, 19.., is £8,000. Sundry assets of £500 at the commencement of the business remain unchanged. There are no other assets save cash and no liabilities.

At 31st December, 19.. (one year after D's admittance) B retires. The other partners purchase his share in the business, including the balance on his current account. The goodwill value of a share is to be taken at £80.

Prepare Partners' Capital, Current, and Loan Accounts, and extract Balance Sheets at 31st December, 19.., (*a*) before and (*b*) after retirement of B.

The opening accounts are—

	£	£
Cash	2,500	
Sundry Assets	500	
Capitals	——	3,000

The cash at the end will be—

	£	s.	d.	£	s.	d.
Balance at commencement	2,500	0	0			
Plus Profit	8,000	0	0			
				10,500	0	0
Less Drawings per—						
Current Account	6,000	0	0			
Loan Account	202	10	0			
				6,202	10	0
				£4,297	10	0

The cash paid in by B and D is not retained in the business, but taken out by A and C.

D pays in £975, B £1,300. Total £2,275.
A receives £1,950, C, £325. Total £2,275.
See page 681.

Date		Particulars		A £ s d	B £ s d	C £ s d	D £ s d
19 Jan 1		To Cash—Shares sold to D payment of ½ thereof		650 0 0		325 0 0	
		,, Cash—Shares sold to B		1 300 0 0			
		,, Loan Accounts—½ value of Shares sold to D		650 0 0		325 0 0	
		,, Balances[1]	c/d	1 200 0 0	750 0 0	600 0 0	450 0 0
				£3 800 0 0	£750 0 0	£1 250 0 0	£450 0 0
Dec 31		To *Goodwill*		1 066 13 4		533 6 8	400 0 0
		, Transfer to A, C, D, per Agreement			2,750 0 0		
		,, Balances	c/d	1,600 0 0		800 0 0	600 0 0
				£2,666 13 4	£2 750 0 0	£1 333 6 8	£1,000 0 0

Date		Particulars		A £ s d	B £ s d	C £ s d	D £ s d
19 Jan 1		By Balance	b/d	1 800 0 0	450 0 0	750 0 0	
	(a)	Cash—½ payment for 15 Shares at £30 each					225 0 0
	(b)	,, Cash—½ payment for 15 Shares at £100 each in respect of Goodwill purchased by D		500 0 0		250 0 0	
	(a)	,, D Loan Account—Balance for 15 Shares at £30 each transferred					225 0 0
	(b)	,, D Loan Account—Balance for 15 Shares at £100 each for Goodwill transferred		500 0 0		250 0 0	
	(a)	Cash—payment for 10 Shares purchased from A at £30			300 0 0		
	(b) *See foot note*	,, Cash—payment for 10 Shares in respect of Goodwill at £100 each		1,000 0 0			
				£3 800 0 0	£750 0 0	£1,250 0 0	£450 0 0
Jan 1		By Balances	b/d	1,200 0 0	750 0 0	600 0 0	450 0 0
Dec 31		, *Goodwill*			2,000 0 0		
		,, Transfer from B, Shares purchased		1,466 13 4		733 6 8	550 0 0
				£2 666 13 4	£2,750 0 0	£1,333 6 8	£1,000 0 0
19 Jan 1		By Balances	b/d	1,600 0 0		800 0 0	600 0 0

(a) Payment for Capital. (b) Payment for Goodwill

[1] I.e. Shares in Capital

						£	£
A	60 *less* sold	20		= 40	@	30 =	1,200
B	15 *add* bought		10	= 25	@	30 =	750
C	25 *less* sold	5		= 20	@	30 =	600
D	Nil *add* bought		15	= 15	@	30 =	450
	100	25	25	= 100	@	£30 =	£3 000

Dr. **CURRENT ACCOUNTS** **Cr.**

			A £	s.	d.	B £	s.	d.	C £	s.	d.	D £	s.	d.
19.. Dec. 31	To Cash Drawings		2,400	0	0	1,500	0	0	1,200	0	0	900	0	0
	,, Interest on Loan											97	10	0
	,, Transfer to Loan Account											202	10	0
	,, Balances	c/d	865	0	0	500	0	0	432	10	0			
			£3,265	0	0	£2,000	0	0	£1,632	10	0	£1,200	0	0
	To *Transfer to A, C, and D per agreement*					*500*	*0*	*0*						
	,, Balances	c/d	1,131	13	4				565	16	8	100	0	0
			£1,131	13	4	£500	0	0	£565	16	8	£100	0	0

			A £	s.	d.	B £	s.	d.	C £	s.	d.	D £	s.	d.
19.. Dec. 31	By Interest on Loan		65	0	0				32	10	0			
	,, Profit		3,200	0	0	2,000	0	0	1,600	0	0	1,200	0	0
			£3,265	0	0	£2,000	0	0	£1,632	10	0	£1,200	0	0
	By Balances	b/d	865	0	0	500	0	0	432	10	0			
	,, *Transfer from B to A, C, and D*		*266*	*13*	*4*				*133*	*6*	*8*	*100*	*0*	*0*
			£1,131	13	4	£500	0	0	£565	16	8	£100	0	0
19.. Jan. 1	By Balances	b/d	1,131	13	4				565	16	8	100	0	0

Dr. **LOANS** **Cr.**

			A £	s.	d.	B £	s.	d.	C £	s.	d.	D £	s.	d.
19.. Jan. 1	To Transfer from Capital Account											975	0	0
Dec. 31	,, Cash		135	0	0				67	10	0			
	,, Balances	c/d	515	0	0				257	10	0			
			£650	0	0				£325	0	0	£975	0	0
19.. Jan. 1	To Balance	b/d										772	10	0

			A £	s.	d.	B £	s.	d.	C £	s.	d.	D £	s.	d.
19.. Jan. 1	By Transfer from Capital Accounts		650	0	0				325	0	0			
Dec. 31	,, Transfer from Current Account											202	10	0
	,, Balance	c/d										772	10	0
			£650	0	0				£325	0	0	£975	0	0
19.. Jan. 1	By Balances	b/d	515	0	0				257	10	0			

Note. The adjustments on B's retirement are shown in separate sections of the Capital and Current Accounts.

Balance Sheet as at 31st December, 19.. (*before* the Retirement of B)

	£	s.	d.	£	s.	d.		£	s.	d.	£	s.	d.
Capitals—							Cash				4,297	10	0
A	1,200	0	0				Sundry Assets				500	0	0
B	750	0	0				Loan—D[1]				772	10	0
C	600	0	0										
D	450	0	0										
				3,000	0	0							
Current Accounts—													
A	865	0	0										
B	500	0	0										
C	432	10	0										
				1,797	10	0							
Loans—													
A	515	0	0										
C	257	10	0										
				772	10	0							
				£5,570	0	0					£5,570	0	0

[1] As D, by transferring £202 10s. (the balance of his Current Account) to the credit of his Loan Account has in effect drawn out that sum, A and C will draw a like amount in proportion, thus leaving the amount owing to the partners A and C in respect of the loan equal to that owed by D. If the Loan Accounts are to be considered purely personal matters, they will not appear in the books of the firm, and D will withdraw the sum of £202 10s and pay over to A and C £135 and £67 10s. respectively, giving the identical result as regards the partnership, as the Loan Accounts cancel each other.

The problem is not nearly so complex as at first appears. It is clear that the capitals are to be in ratio to the profit-sharing proportions so that the end capitals must be in the ratio of 40 : 25 : 20 : 15, and seeing that the cash introduced by B and D is to be withdrawn, the end capitals will still be £3,000, and the amount to be brought in by D will be $\frac{15}{100} \times$ £3,000 = £450. Actually only one-half of this amount is brought in at present in cash, the balance being on loan, but the effect is just the same so far as the capital is concerned. If the total capital is £3,000, each hundredth must be equal to £30.

The total goodwill must be £100 × 100 = £10,000, and as A sells a $\frac{1}{5}$ proportion (i.e. $\frac{60}{100}$ less $\frac{40}{100}$) he must be credited with £2,000 which is the total amount credited to his account, viz. £500 plus £500 plus £1,000.

Likewise C sells a $\frac{1}{20}$ proportion (i.e. $\frac{25}{100}$ less $\frac{20}{100}$) and so must be credited with £500 ($\frac{1}{20} \times$ £10,000), which is the total credited to his account, viz. £250 plus £250.

Once the significance of the phraseology is grasped, the problem of goodwill and capital can be dealt with on the lines already outlined on previous pages, e.g. if the goodwill account were created it would be debited with £10,000, and credits would be—

A £6,000, B £1,500, C £2,500, Total: £10,000.

If reversed, the goodwill would be eliminated and the debits would be—

A £4,000, B £2,500, C £2,000, D £1,500, Total: £10,000.

Combined, the results would be—

	Dr.	*Cr.*
	£	£
A . . .		2,000
B . . .	1,000	
C . . .		500
D . .	1,500	
	£2,500	£2,500

In the accounts outlined, A and C are duly credited with these figures, whilst B is credited with £300 and D £450, which are the total contributions of B (£1,300 less debit as above £1,000), and D (£1,950 less debit as above £1,500). As has been shown, if the *whole* goodwill is put through the books, the contributions for *both* goodwill and capital must be credited to the contributing partners, and on reversal the "pure" capital contributions will remain in the books.

In regard to the retiring partner B, he is selling his twenty-five shares of the capital and goodwill to the other partners.

The whole goodwill now being valued at £8,000, i.e. 100 shares of £80 each, will be as shown on page 685.

GOODWILL ADJUSTMENTS STATEMENT

	A		B		C		D	
		£ s. d.		£ s. d.		£ s. d.		£ s. d.
Old Shares	40%	3,200 0 0	25%	2,000 0 0	20%	1,600 0 0	15%	1,200 0 0
New Shares	53⅓%	4,266 13 4	Nil	Nil	26⅔%	2,133 6 8	20%	1,600 0 0
Differences	− 13⅓%	*Dr.* £1,066 13 4	+ 25%	*Cr.* £2,000 0 0	− 6⅔%	*Dr.* £533 6 8	− 5%	*Dr.* £400 0 0

The Journal entry is—

JOURNAL

		£	s.	d.	£	s.	d.
A Capital . . . . . . *Dr.*	(*b*)	1,066	13	4			
C ,, ... *Dr.*	(*d*)	533	6	8			
D ,, ... *Dr*	(*f*)	400	0	0			
To B Capital					2,000	0	0
Being shares of Goodwill taken over from B by continuing partners.							

At this stage, therefore, B is in credit for £2,750, being his capital of £750 plus his share of goodwill, as above, £2,000. In addition, his Current Account is in credit for £500.

The acquisition of B's Capital balance of £2,750 will be recorded in the Journal thus—

JOURNAL

	£	s.	d.		£	s.	d.
B Capital . . . . . . *Dr.*	2,750	0	0				
To A Capital				(*a*)	1,466	13	4[1]
,, C ,, ...				(*c*)	733	6	8[1]
,, D ,, ...				(*e*)	550	0	0[1]
Being shares of Capital and Goodwill purchased from B by continuing partners as agreed.							

The Capital Accounts (as a result of the above entries) are now—

	A	C	D
	£	£	£
Balances per previous Balance Sheet . .	1,200	600	450
Adjustments	400 (*a* − *b*)	200 (*c* − *d*)	150 (*e* − *f*)
Total (see page 686) . .	£1,600	£800	£600

[1] Ratios of 53⅓% : 26⅔% : 20% of £2,750.

Balance Sheet as at 31st December, 19.. (*after* Retirement of B)

	£	s.	d.	£	s.	d.		£	s.	d.	£	s.	d.
Capitals (*a*)—							Cash				4,297	10	0
A	1,600	0	0				Sundry Assets				500	0	0
C	800	0	0				D—Loan				772	10	0
D	600	0	0										
				3,000	0	0							
Current Accounts (*b*)—													
A	1,131	13	4										
C	565	16	8										
D	100	0	0										
				1,797	10	0							
Loans—													
A	515	0	0										
C	257	10	0										
				772	10	0							
				£5,570	0	0					£5,570	0	0

(*a*) These are respectively 53⅓ per cent, 26⅔ per cent, and 20 per cent of 100 shares of £30 each.
(*b*) If the Current Accounts are to be in "ratio," there will be a cash adjustment between the partners.

The Current Accounts transfers will be journalized thus—

JOURNAL

		£	s.	d.	£	s.	d.
B Current Account . . . . . *Dr.*		500	0	0			
To A Current Account . . .					266	13	4
,, C ,, ,, ...					133	6	8
,, D ,, ,, ...					100	0	0
Being B's Current Account taken over by the continuing partners.							

CURRENT ACCOUNTS

	A			B			C			D		
	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.
Balances, from last Balance Sheet .	865	0	0	500	0	0	432	10	0	Nil		
Adjustments, as above	+ 266	13	4	− 500	0	0	+ 133	6	8	100	0	0
Balances (see page 686)	£1,131	13	4	Nil			£565	16	8	£100	0	0

Illustration. A and B are in partnership as equal partners. A, by agreement, retires and his son S joins the firm on a basis of one-third share of profits.

The balances on the books were—

	Dr.	*Cr.*
	£	£
Goodwill	1,200	
Bank.	800	
Other Assets	5,900	
Creditors		400
Capital Accounts: A		3,800
B		3,700
	£7,900	£7,900

Goodwill is agreed at £3,000 and written up accordingly. Sufficient money is to be introduced so as to enable A to be paid off and leave £500 cash in bank; B and S are to provide such sum as will make their capitals proportionate to their shares of profit. A agrees to contribute from his Capital half of the amount S has to provide.

Assuming the arrangement was carried out show the journal entries required.

JOURNAL

		£	£
Goodwill . . . . Dr.		1,800	
To Capital—A			900
,, Capital—B			900
Increase in value of Goodwill on dissolution.			
Capital—A . . . . Dr.		1,500	
To Capital—S			1,500
Half amount required from S contributed by A, as follows—			
Capital A revalued	£4,700		
Capital B revalued	4,600		
	9,300		
Less Cash available [£800 – 500]	300		
Proposed amended Capital of which—	£9,000		
S is to pay one-third	£3,000		
Half thereof	£1,500		
Cash . . . . Dr.		2,900	
To B			1,400
,, S			1,500
Cash required—			
B—two-thirds	£6,000		
Less existing revalued Capital	4,600		
	£1,400		
S—Half of £3,000	£1,500		
Capital—A . . . . Dr.		3,200[1]	
To Cash			3,200
Balance due	£4,700		
Less Gift to S	1,500		
	£3,200		

[1] This is equal to the following—

	£
(1) Cash at Bank available for A [£800 – £500] . .	300
(2) Amount paid in by B	1,400
(3) Amount paid in by S	1,500
	£3,200

The revised Balances would be—

	Dr. £	Cr.
Goodwill [£1,200 + £1,800]	3,000	
Cash at Bank [£800 + £1,400 + £1,500 – £3,200]	500	
Other Assets	5,900	
Creditors		400
A [£3,800 + £900 – £1,500 – £3,200]		—
B [£3,700 + £900 + £1,400]		6,000
S [£1,500 (from father) + [£1,500 (Cash)]		3,000
	£9,400	£9,400

SECTION (F) CONTINUANCE OF PERSONNEL WITH REVISED PROFIT-SHARING RATIO

Where the same partners continue in business but decide upon a change in PROFIT-SHARING ratios, the position may be regarded as if there had been a change in personnel, that is an old firm and a new one for the purpose of adjusting assets (including goodwill) and liabilities.

The procedure will follow the usual lines as on a change in personnel, the revaluation being necessary so that profits or losses may be dealt with in favour of or against the partners in their proper proportions.

Illustration. The following are the Capital Accounts of A, B, and C sharing profits 2 : 2 : 1.

	£
A	2,000
B	1,400
C	1,000
	£4,400

No goodwill appears in the books. It is decided that they shall share profits in future in the proportions 4 : 3 : 1. For this purpose the assets are to be written down by £100 and the goodwill to be taken as worth £900. Capitals are then to be adjusted (by cash payments) to the same proportions as the new profit-sharing ratios and no alterations are to be made to book values.

Show Ledger entries. (See page 690.)

INTEREST ON CAPITAL

If the partnership agreement provides for interest on capital it has the effect of giving a certain portion of trading profits in the capital ratio, i.e. by way of interest on capital, so that the "net" influence of the changed ratio is not synonymous with the "gross." For instance, two partners may previously have shared profits equally, and agree to revise the ratio to 3 : 1. The difference as between each is nominally from 1 : 1 to 3 : 1, but if interest on capital is allowed a certain proportion of the profits will be thus absorbed.

Illustration. A and B are partners sharing profits equally, after allowing 5 per cent interest on their capitals of £8,000 and £7,000. Assets, including goodwill, are to be reduced by £10,000 and thereafter profits are to be shared as to 4 : 1 after providing interest on capital at 5 per cent per annum on their revised capitals. The profit before taking into account interest on capital is £1,250.

Show the division of profit in both the old and the new manner. (See page 691.)

Dr. *Memorandum* REVALUATION ACCOUNT *Cr.*

		£			£
To Depreciation of Assets . . .	c/d	100	By Appreciation of Asset—Goodwill .	c/d	900
,, Profit on Revaluation—					
A: 2/5 . . . £320					
B: 2/5 . . . 320					
C: 1/5 . . . 160		800			
		£900			£900
To Reversal of Item	b/d	900	By Reversal of Item	b/d	100
			,, A: 4/8 . . . . . £400		
			,, B: 3/8 300		
			,, C: 1/8 100		800
		£900			£900

Dr. CAPITALS *Cr.*

		A	B	C			A	B	C
		£	£	£			£	£	£
To Profit on Revaluation written back		(x) 400	(y) 300	(z) 100	By Balances . .	b/d	2,000	1,400	1,000
,, Cash . . .				510	,, Profit on Revaluation . . .		(x) 320	(y) 320	(z) 160
,, Balances—(a) .	c/d	(4/8) 2,200	(3/8) 1,650	(1/8) 550	,, Cash . . .		280	230	
		£2,600	£1,950	£1,160			£2,600	£1,950	£1,160
					By Balances . .	b/d	2,200	1,650	550

(a) Based upon "book value" capital, i.e. £4,400. The cash paid in by A and B equals the amount received by C.

	A	B	Total
(1) *Old Division—*	£	£	£
Interest on Capital	400	350	750
Profits equally	250	250	500
	£650	£600	£1,250
(2) *New Division—*			
Interest on Capital	150	100	250
Profits 4 : 1	800	200	1,000
	£950	£300	£1,250

It will be seen that, in the new division, the first £250 is absorbed in interest on capital, leaving an extra £500 divisible profit. The partners lose on interest on capital £500 [i.e. £750 – £250] equally, as can be seen above. This must be so because the interest is at the same rate as before but upon a lower capital and the capitals have been reduced EQUALLY by the loss on revaluation, which the partners bear equally. Thus, the difference between the profits to A and B in the new and old ratios is explained—

£	
250	Interest. A takes £50 more than B in both instances
500	"Released" Interest, now as divisible profit
500	other profit
£1,000	new divisible profit, as above.

This may be further explained in the following table—

	New	Old						Old	New
A gains	$\frac{4}{5}$	– $\frac{1}{2}$	= $\frac{3}{10}$	× £1,000	=	£300,	i.e.	£650	£950
	Old	New							
B loses	$\frac{1}{2}$	– $\frac{1}{5}$	= $\frac{3}{10}$	× £1,000	=	£300,	i.e.	£600	£300

It must further be remembered that A will gain on any capital profit, e.g. assuming that the assets fetch the old book values, A will gain £3,000 [i.e. $\frac{3}{10}$ × £10,000] as he was previously debited with his *half* share of the capital loss, i.e. £5,000, and will now be credited with *four-fifths* of the capital gain, i.e. £8,000.

Subsequent Receipts of Debts Written Off, etc.

Where assets, e.g. debtors, are written off wholly or in part, it is a question of importance to determine upon a change in profit-sharing ratios whether it represents a revaluation or not.

(1) If the former, any subsequent appreciation or profit upon the revised book value, e.g. receipt of a debt written off as bad, must be credited to the new partners in the *new* ratio.

(2) If the writing off was merely a precautionary measure, then any appreciation subsequent to the change in constitution will be credited to the old partners in the *old* ratio.

Where the Memorandum Revaluation method is employed, it will be obvious that the assets still remain undisturbed in the books, and the entries will be as in either (3) or (4).

(3) Where a true revaluation is made and the amount considered bad at the date of the change—

Dr. Old partners in the old ratio.
Cr. New partners in the new ratio.

(*a*) The amount subsequently received will be credited to the DEBTORS accounts (debts not having been actually written off as in the Memorandum Revaluation system, the book values of assets remain unchanged). The partners' accounts will, therefore, not be credited as they would in the case of an ordinary writing-off as in (1) and (2), the partners already having obtained the benefit in the new ratio by entry in the Memorandum Revaluation Account.

(*b*) If the asset proves to be finally bad, the loss will be written off in the new ratio.

(4) Where there is merely a "precautionary" adjustment, at the date of the change—

Dr. Old partners in the old ratio.
Cr. New partners in the old ratio.

(*a*) The amount subsequently received will be credited to the DEBTORS accounts (debts not having been actually written off, as in the Memorandum Revaluation system the book values of assets remain unchanged). The partners' accounts will, therefore, not be credited as they would in the case of an ordinary writing-off as in (1) and (2), the partners having obtained the benefit in the old ratio by the entry in the Memorandum Revaluation Account.

(*b*) If the asset proves to be bad, the loss may be considered to have taken place in the course of the new partnership, and will be debited to the partners in the *new* ratio.

Illustration. A and B were partners sharing profits and losses equally. On 31st December, 19.., they decided to share profits and losses in future in the ratio of 3 : 2. Bad Debts were written off amounting to £100 on the date of the change, and in the following year the amount written off was received in full. Show entries relating to the above.

	Entries at Date of Change				*Entries on Receipt of Cash*			
(1)	Debit A	£50	Credit Debtors	£100	Debit Cash	£100	Credit Debtors	£100
	,, B	£50						
					Debit Debtors	£100	Credit A	£60
							,, B	£40
							(through the Profit and Loss Account)	
(2)	Debit A	£50	Credit Debtors	£100	Debit Cash	£100	Credit Debtors	£100
	,, B	£50			Debit Debtors	£100	Credit A	£50
							,, B	£50
							(through the Profit and Loss Account)	
(3a)	Debit A	£50	Credit Memorandum Revaluation Account	£100	Debit Cash	£100	Credit Debtors	£100
	,, B	£50						
	Debit Memorandum Revaluation Account	£100	Credit A	£60				
			,, B	£40				
(4a)	Debit A	£50	Credit Memorandum Revaluation Account	£100	Debit Cash	£100	Credit Debtors	£100
	,, B	£50						
	Debit Memorandum Revaluation Account	£100	Credit A	£50				
			,, B	£50				

Illustration. In reference to the preceding illustration, if no amount is received in respect of the Bad Debts the entries already made at the date of change will remain undisturbed and no receipts at all will appear in the right hand column above.

As no actual writing off has taken place in (3*a*) and (4*a*) the entry for actual writing off the debts will be—

(3*b*)	Debit A £60	Credit Debtors £100
	,, B £40	
(4*b*)	Debit A £60	Credit Debtors £100
	,, B £40	
	(through the Profit and Loss Account in each case)	

The position of (1) and (2) is clear, but in regard to (3) the effect of the entries representing a true revaluation may be seen in reference to the non-receipt of the cash. The partners were debited equally (3*a*) and *credited* in the ratio of 3 : 2 (3*a*), and when the debt proved to be bad the partners were *debited* in the ratio of 3 : 2 (3*b*), thus leaving the partners in debit equally—the true allocation of loss as the debts were considered bad at the date of the change, thus being a loss of the "old" firm.

In regard to (4) the debts were not considered bad, so that when the adjustment takes place the loss must be taken as appertaining to the "new" firm. This may be seen by the combined effect of entries in (4*a*) and (4*b*). In the former A and B were debited and credited equally, and in the latter (4*b*) were debited in the ratio of 3 : 2. As the entries in (4*a*) cancel each other the "new" firm is debited with the loss in the ratio of 3 : 2 by the entry in (4*b*).

Alternatively, the entries in (4) at the date of change need not be made, and subsequently the new partners' Capital Accounts will be debited in the new ratio (if the debts prove bad), or cash debited and Debtors Accounts credited (if the debts are received).

General Illustration. A and B are in partnership sharing profits

as follows: 8 per cent interest on capital, one-quarter of the remaining profits to B in salary, the residue between A and B as to 3 : 2. They hold as a partnership asset shares which cost £4,000: A considers them to be worth £6,500 and proposes that they shall be written up to that value, and that henceforth the profit-sharing ratio between A and B shall be 8 : 7, B's salary arrangement being as before. Interest on capitals are to continue at 8 per cent. What is B's position (1) on the old basis, (2) on the new basis?

(1) *Old Basis*. As the capitals of A and B will be augmented by the credit in respect of the written-up value of the shares, there will accordingly be an increase of INTEREST on capital to the extent of 8 per cent on the increased capital of £2,500, i.e. £200, allocated as follows—

A, $\frac{3}{5}$ = £120. B, $\frac{2}{5}$ = £80. Total, £200.

(the capital increase being credited to the partners in the old profit-sharing ratios, viz. 3 : 2). This will reduce the remaining profits by £200.

	A	B	Total
Interest on Capital	+ £120	+ £80	+ £200
Divisible profits will be reduced by £200 and borne in the ratio 45 : 55 (*see below*)	− £90	− £110	− £200
Net result . . .	+ £30	− £30	

Under the first method of sharing profits the division was—

	A	B	Total
Salary		25%	25%
Remainder	45%	30%	75%
Total	45%	55%	100%

If the old profit sharing ratio continues, B loses £30 of profits annually by the writing up of the asset.

Assume profits, after providing interest on original Capital, are £1,000.

(1*a*) Division *before* the writing up of asset—

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

		£			£
To Salary: B		250	By Balance . . .	b/d	1,000
„ Balance—					
A: $\frac{3}{5}$ . . .	£450				
B: $\frac{2}{5}$ . . .	300				
		750			
		£1,000			£1,000

(1*b*) Division *after* writing up of asset—

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

			£			£
To Interest on Capital—				By Balance . . .	b/d	1,000
A . . .	£120					
B . . .	80					
			200			
,, Balance . . .		c/d	800			
			£1,000			£1,000
To Salary: B .	25%		200	By Balance . . .	b/d	800
,, Balance—						
A: 3/5 . .	£360					
B: 2/5 . .	240					
			600			
			£800			£800

Alternatively (1*b*) may be shown as follows—

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

			£			£
To Interest on Capital—				By Balance . . .	b/d	1,000
A . . .	£120					
B . . .	80					
			200			
,, Balance—						
A: 45% . .	£360					
B: 55% . .	440					
			800			
			£1,000			£1,000

It will be observed that the partners receive the same by both alternative methods of (1*b*), i.e. A, £480 : B, £520, as compared with the amounts receivable before the writing up of the asset, i.e. A, £450 : B, £550.

Thus, if the profit sharing basis after providing for interest on capital remains unchanged, B loses £30 of profits annually.

(2) *New Basis.* Under the proposed method of sharing profits the division will be—

	A	B	Total
Salary		25%	25%
Remainder	40%	35%	75%
Total	40%	60%	100%

The remaining profits will, as before, be reduced by £200, giving the result as follows—

	A	B	Total
Interest on Capital	+ £120	+ £80	+ £200
Divisible profits will be reduced by £200 and borne in the ratio of 40 : 60* .	− £80	− £120	− £200
Net result	+ £40	− £40	

* See Table at foot of page 695.

B thus loses by the writing up of the asset, but gains 5 per cent increase in remaining profits: 60 per cent less 55 per cent (per old division).

Therefore, the proposed scheme will be advantageous to B if the profits after interest on *original* capital exceed $\frac{100}{5} \times £40 = £800$, and will be detrimental if the profits are less than £800; or where the remaining profits *after* interest on the *revised* capital exceed $\frac{75}{5} \times £40 = £600$, the scheme will be advantageous to B and *vice versa*. Alternatively, as mentioned, if the profits remain unchanged B loses £30, and as he gains 5% of profits after charging interest the increased profits to cover his loss must be £600.

The position as regards capital losses and profits must also be considered.

(1) As regards losses, B will now bear any capital loss in the new ratio 8 : 7 instead of in the old ratio 3 : 2. He will thus have to bear a further $\frac{1}{15}$ of any capital loss, i.e. $\frac{7}{15} - \frac{6}{15} = \frac{1}{15}$.

(2) As regards profits, B will now receive any trading profit in the new ratio 40 : 60 instead of in the old ratio 45 : 55, and thus he gains a further 5 per cent on any trading profit under the new arrangement.

On the other hand, capital profits, not being *trading* profits, will not be taken into account for the purpose of calculating B's salary, hence they would be shared in the ratio 8 : 7 instead of in the old ratio 3 : 2, and thus B would gain a further $\frac{1}{15}$ under the proposed new arrangement.[1]

Note. The *original* capitals of the partners are of no consequence, as the partners will receive the same amount of interest on capital under both the new and old arrangements as regards such original portion of their capitals.

The contrast between the old and the new divisions may now be shown.

Illustration. Assume that the profits *after* providing interest on original capital are £800.

[1] (The original capital profit of £2,500 was treated in this manner and divided in the ratio 3 : 2, and not in the trading profits ratio 45 : 55.)

(1) *Old Basis.*

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

			£			£
To Salary: B 25%			200	By Balance	b/d	800
" Balance—						
A: $\frac{3}{5}$	£360					
B: $\frac{2}{5}$	240					
			600			
			£800			£800

(2) *New Basis.*

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

			£			£
To Interest on Capital—				By Balance	b/d	800
A	£120					
B	80					
			200			
" Balance		c/d	600			
			£800			£800
To Salary: B 25%			150	By Balance	b/d	600
" Balance—						
A: $\frac{8}{15}$	£240					
B: $\frac{7}{15}$	210		450			
			£600			£600

Alternatively (2) may be shown as follows—

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

			£			£
To Interest on Capital—				By Balance	b/d	800
A	£120					
B	80					
			200			
" Balance—						
A: 40%	£240					
B: 60%	360					
			600			
			£800			£800

It will be observed that the partners receive the same in both (1) and (2), i.e. A £360, B £440.

Where the profits after providing interest on original capital exceed £800 the proposition is advantageous to B, e.g. if the trading profits were £2,000 B would (in all) receive £1,100 under the old arrangement, and £1,160 under the proposed new arrangement.

The trading profits at the "margin" are thus £800 plus interest on *original* capital. If their original capitals were, say, A £5,000, B £4,000, the "margin" profits before charging any interest on capital would be £1,520, thus—

	£	£	£
Original Profits			1,520
Less Interest on *original* Capital: 8 per cent on £9,000			720
Balance after charging Interest on *original* Capital			800
Less Interest on *increased* Capitals—			
A	120		
B	80		
			200
Balance after charging Interest on *revised* Capital			600
Less B— Salary		150	
Balance of Profits—			
A: $\frac{8}{15}$	240		
B: $\frac{7}{15}$	210		
		450	600

In practice, the interest on capital would be shown in the accounts debited in one total and would not be split up into two portions.

Alternatively, the required minimum figure to compensate B may be found by simple algebra.

Let P = profits *after* interest on original capital

then $\frac{55}{100}P = 80 + \frac{60}{100}(P - 200)$

$55P = 8{,}000 + 60P - 12{,}000$

$5P = 4{,}000$

$\therefore \quad P = £800$

B receives the same amount of the profits (*after* providing for interest on *original* capital) when they are £800 under both the old and the new basis.

SECTION (G) ANNUITIES

The question of annuities is treated separately, although its place is essentially amongst the problems arising upon the retirement of a partner. This separation has been made because the old partners may bring in a new partner, and there may be subsequent changes in personnel and/or profit-sharing ratios; and the treatment under all these circumstances may be best shown under one heading rather than by separate working under each particular section.

Annuity to Retiring Partner and its Treatment in Partnership Changes. It may be convenient for all parties to agree to pay a retired partner or in the case of the death of partner to pay the widow and/or children by means of an annuity, that is, a yearly payment either for life or terminable at the end of a certain number of years; or an agreement may be reached to pay a certain amount of the indebtedness of the firm to the retired partner at once and to discharge the balance in the above-mentioned manner. The problem does not affect the principles of ascertaining the balance due, but its *discharge*.

There are many ways of dealing with the annuity and space will not permit of full treatment of each, so that the alternative methods will be shown below, and the more important aspects illustrated. The annuity payments may be treated thus—

(1) Debit Capital or Current Accounts in Profit and Loss ratios.
Credit Cash.[1]

(2) Debit Drawings Accounts similarly.
Credit Cash.[1]

(3) Debit Profit and Loss Account.
Credit Cash.[1]

(4) Debit Reserve Account.
Credit Cash.[1]

In the above instances the balance due to the retired partner after making the usual adjustments for revaluation of liabilities and assets, including goodwill, will on his retirement be credited to the Capital or Current Accounts of the continuing partners in Profit and Loss ratios and debited to the retired partner.

(5) Debit Capital or Loan Account of retired partner.
Credit Cash [just as if they had discharged the debt by ordinary payment] if and when the continuing partners actually PURCHASE the required Annuity from an Insurance Company.

(6) Debit Capital or Loan Account of retired partner.
Credit Annuity Suspense Account at the date of retirement and the yearly payments will be then treated thus—
Debit Annuity Suspense Account.
Credit Cash.[2]

(7) Debit Capital or Loan Account of retired partner.
Credit the continuing partners, the latter paying in their shares of the Annuity payments due, no further entries being made in the partnership books.

The death of the retired partner or expiry of time will not cause further entries in the partnership books except in (6), where the balance will be transferred to the Capital or Current Accounts of the continuing partners.

It is quite possible that there may be a combination of the above methods where the continuing partners decide to buy part of the annuity and discharge the balance themselves, treating their own yearly payments either by methods (1) to (4) on the one hand, or by method (6) on the other.

[1] Actually the credit will be made to the retired Partner's Annuity Account, and the latter account debited with Cash and Income Tax

[2] Occasionally, the continuing partners agree to become personally liable for the payments of the annuity in the profit and loss ratios, thus involving no further entries in the partnership books. Interest may be brought into account by crediting the Annuity Suspense Account and debiting Profit and Loss Account for such Interest, the annuity liability being taken as analogous to a loan by the firm repayable in instalments.

Where an Annuity to the retired partner (or widow and child) is paid for his share of the unrecorded Goodwill, a method sometimes adopted is to debit the annual payments for such share to Goodwill Account. Strictly, when the total payments reach the share of goodwill the continuing payments are losses of capital by reason of the continuing partners having to pay more than the share of the goodwill attributable to the retired partner, and these further payments ought to be debited to the continuing partners' drawings accounts. They could be continued to be charged to the Goodwill Account until the value of the Goodwill at the time of retirement had been reached and subsequent payments charged to drawings accounts in profit ratios. On a dissolution the net effect would be the same whichever alternative in this paragraph were adopted because, if the payments are debited to drawings instead of Goodwill, there would be a correspondingly larger sum debited to Goodwill and credited to the partners to bring the Goodwill up to its current value.

This method is very undesirable inasmuch as if the charges to Goodwill cease after reaching the outgoing partner's share, the amount in the books representing Goodwill is merely the premium on the outgoing partner's share and in any case the true value of the Goodwill as at the date of retirement is not shown till such time as the continued payments to the outgoing partner have reached that figure. Furthermore in case of change in profit ratios and/or personnel, the adjustments become complicated.

The above principles postulate a continuity of *the constitution of the partnership*. When a change in constitution occurs important considerations arise necessitating the application of the rules previously indicated, viz. that upon a change REVALUATIONS are required. Both positions will now be illustrated.

(1) CONTINUITY

Illustration. A, B, and C sharing profits in the ratio of 1 : 4 : 1 agree to dissolve as on 31st December, 1951. Their respective capitals after all adjustments have been considered, agreed and dealt with, are £6,000, £9,000, and £2,000. B agrees to have a life annuity of £450 in full discharge of his interest in the firm. A and C are to continue and divide profits and losses in the ratio of 3 : 1.

The first annuity is paid on 31st December, 1952. Write up Ledger Accounts. [The accounts appear on page 701.]

Methods 1–4.

The above example illustrates points 1, 2, 3, and 4, and although there are various alternatives as regards the particular account to be debited, the effects are (1) to consider the liability to the old partner as a gain to the new partnership, and (2) to consider each annuity payment as a partnership loss for the year in question.

Dr. CAPITALS **Cr.**

			A	B	C				A	B	C
1951			£	£	£	1951			£	£	£
Dec. 31	To Transfer to A [1]			6,750		Dec. 31	By Balances	b/d	6,000	9,000	2,000
	,, ,, ,, C [1]			2,250			,, Transfer from B		6,750		2,250
	,, Balances	c/d	12,750		4,250						
		£	12,750	£9,000	£4,250			£	12,750	£9,000	£4,250
						1952					
						Jan. 1	By Balances	b/d	12,750		4,250

[1] I.e. 3 : 1.

On Payment of Annuity (First Year)

Dr. B ANNUITY **Cr.**

			£	s.	d.				£	s.	d.
1952						1952					
Dec. 31	To Cash		236	5	0	Dec. 31	By Profit and Loss Account[1]		450	0	0
	,, Income Tax at 9s. 6d. in £		213	15	0						
			£450	0	0				£450	0	0

[1] Alternatively, the posting may be made to Current, Drawings (divided in Profit and Loss ratios, i.e. 3 : 1), or to Reserve Account.

Method 5.

Where the annuity is PURCHASED, the cost of the annuity may be considered as the equivalent of payment to the partner, and as no payments of the annuity will be made by the continuing partners but by the Insurance Office the matter ends with the payment of the purchase price of the annuity to the Insurance Company, unless the latter hands the required sum to the partners for them to make the actual payment, and in such circumstances the Cash Book will have a contra entry, viz., the receipt of the annuity from the company and the payment to the annuitant.

Illustration. If A and C decided to purchase the annuity the entry would be (assuming that the cost exactly equals the amount due to B): Debit B Capital, £9,000; Credit cash, £9,000.

If, say, half the annuity was purchased, the entries would be—

(1) Debit B, £4,500. Credit Cash, £4,500.
" " £4,500. Credit Capitals A £3,375. C £1,125.

(2) Annuity payment borne by firm £225 (instead of £450) less Income Tax.

Method 6—see page 703.

Death of Annuitant. No entries will be involved in respect of methods 1–5, but under method 6 the balance of the Annuity Suspense Account will be closed off to the benefit of partners in one of the ways previously outlined.

Illustration. Assuming that B died on 12th January, 1954, the Annuity Suspense Account having been revalued as follows: 31st December, 1952, £8,500; 31st December, 1953, £7,980, show Ledger Accounts.

CAPITAL ACCOUNTS (CREDIT SIDE)

		A	C
By Balances	b/d	£6,000	£2,000

Dr. ANNUITY SUSPENSE *Cr.*

			£				£
1952 Dec. 31	To Annuity Account		450	1952 Jan. 1	By Transfer - B Capital Account		9,000
	" Profit and Loss (or Capital, etc.) Account		50				
	" Balance	c/d	8,500				
			£9,000				£9,000
1953 Dec. 31	To Annuity Account		450	1953 Jan. 1	By Balance	b/d	8,500
	" Profit and Loss (or Capital, etc.) Account		70				
	" Balance	c/d	7,980				
			£8,500				£8,500
1954 Jan. 12	To Profit and Loss (or Capital, etc.) Account [1]		7,980	1954 Jan. 1	By Balance	b/d	7,980
			£7,980				£7,980

[1] If transferred to Capital Accounts the above Capitals would be credited thus—
A $\frac{3}{4}$ × £7,980 = £5,985 C $\frac{1}{4}$ × £7,980 = £1,995

Method 6.

Illustration. The same facts as before.

Dr. CAPITALS *Cr.*

			A	B	C				A	B	C
			£	£	£				£	£	£
1951 Dec. 31	To Balances	c/d	6,000		2,000	1951 Dec. 31	By Balances	b/d	6,000	9,000	2,000
	,, Transfer—Annuity Suspense Account			9,000							
			£6,000	£9,000	£2,000				£6,000	£9,000	£2,000
						1952 Jan. 1	By Balances	b/d	6,000		2,000

Dr. ANNUITY SUSPENSE *Cr.*

			£	s.	d.				£	s.	d.
1952 Dec. 31	To Annuity Account [1]		450	0	0	1952 Jan. 1	By Transfer—B Capital Account		9,000	0	0
	,, Balance [2]	c/d	8,550	0	0						
			£9,000	0	0				£9,000	0	0
						1953 Jan. 1	By Balance	b/d	8,550	0	0

[1] Dealt with as in the preceding illustration.

[2] The actuarial liability may be recomputed each year, (although this is somewhat exceptional in practice), and the difference between the book liability and the actuarial liability written off to Profit and Loss, Drawings, Capital, Current or Reserve Account, e.g. if the actuarial value, say, at the end of the first year were £8,500, instead of bringing down £8,550, the former amount would be brought down, the remaining £50 being transferred to the benefit of partners as just indicated. (See page 702.)

(2) WHERE A CHANGE IN THE CONSTITUTION OF THE PARTNERSHIP TAKES PLACE

(a) **Introduction of New Partner.** (1) The old partners may continue to deal with the payments (unless the annuity has been purchased) as between themselves, in which case the entries will be precisely as before, except that the new partner cannot be expected to bear part of the cost of the annuity which is but an instalment payment of a liability existing before he was admitted into the business; hence Profit and Loss must not be debited, otherwise the new partner bears a share of the annuity cost, unless at the commencement of the new partnership the new partner was *credited* and the other partners *debited* with the proportion (rateable to profit shares) of the estimated amount of the annuity liability. Such an adjusting entry will, without injustice to the new partner, enable the partnership henceforth to treat the payments as a firm charge.

Illustration. In reference to the preceding illustration, on 1st January, 1953, D is admitted a partner with a fifth share, A and C continuing to share as between themselves 3 : 1. Show Accounts.

On 1st January, 1953, the estimated liability of the annuity being £8,500, it will be necessary either (1) to compel A and C to bear (through their Capital, Drawings, or Current Accounts) the annual payment; or (2) to debit A and C and credit D (as below) if the charge is to be made a firm charge, that is, debited to the Profit and Loss Account or to Capital, etc., Accounts of ALL partners in the profit and loss ratio of the firm as newly constituted.

The debit and credit adjustments for this purpose are—

	£	£
Debit A, $\frac{3}{4} \times \frac{1}{5} \times$ £8,500	1,275	
,, C, $\frac{1}{4} \times \frac{1}{5} \times$ £8,500	425	
Credit D, $\frac{1}{5} \times$ £8,500		1,700

The adjustments may be made on lines similar to those discussed in reference to goodwill (entries being opposite).

ANNUITY LIABILITY ADJUSTMENT SCHEDULE
(Liability £8,500)

	A	C	D
Old Share	$\frac{3}{4}$	$\frac{1}{4}$	
New Share	$\frac{3}{5}$	$\frac{1}{5}$	$\frac{1}{5}$
Differences	$-\frac{3}{20}$	$-\frac{1}{20}$	$+\frac{4}{20}$
Liability	£1,275 *Dr.*	£425 *Dr.*	£1,700 *Cr.*

(2) If the Annuity Suspense Account is employed, the liability will be shown thus—

Dr. ANNUITY SUSPENSE *Cr.*

1953			£	1953			£
Dec. 31	To Annuity Account .		450	Jan. 1	By Balance . . .	b/d	8,500
	„ Profit and Loss Account .		70				
	„ Balance . . .	c/d	7,980				
			£8,500				£8,500
1954				1954			
Jan. 12	To Profit and Loss Account .		7,980	Jan. 1	By Balance . . .	b/d	7,980
			£7,980				£7,980

As the liability appears in the books at 1st January, 1953, the whole of the profits belong to the three partners in their profit and loss ratios, thus—

	Total			A			B			C		
	£	s.	d.	£	s.	d.	£	s.	d.	£	s.	d.
Profit in 2nd year .	70	0	0									
„ „ 3rd „	7,980	0	0									
	8,050	0	0	$\frac{3}{5}$ 4,830	0	0	$\frac{1}{5}$ 1,610	0	0	$\frac{1}{5}$ 1,610	0	0
Profit in 1st year[1] .	50	0	0	$\frac{3}{4}$ 37	10	0	$\frac{1}{4}$ 12	10	0			
	£8,100	0	0	£4,867	10	0	£1,622	10	0	£1,610	0	0

[1] See page 702.

(*b*) **Retirement, and Retirement and Admission.** Similar principles apply as laid down in preceding paragraphs.

Illustration. In reference to the preceding illustrations: (*a*) If on 1st January, 1953, A retired, C continuing alone, it would be necessary to debit A with $\frac{3}{4}$ × £8,500 and C $\frac{1}{4}$ × £8,500, credit C with £8,500, or *debit* A and *credit* C with $\frac{3}{4}$ × £8,500 = £6,375, so that C in future bears the onus of discharging the liability.

(*b*) If on 1st January, 1953, A retired and upon the same date D was admitted to a fifth share, it would be necessary to *debit* A with $\frac{3}{4}$ × £8,500 and C $\frac{1}{4}$ × £8,500; *credit* C with $\frac{4}{5}$ × £8,500 and D $\frac{1}{5}$ × £8,500, i.e.—

Debit A £6,375	Credit C £6,800
„ C £2,125	„ D £1,700

or, more shortly—

Debit A £6,375	Credit C £4,675
	„ D £1,700

(*c*) **Change in Profit-sharing Ratios.** The same principle applies, viz. that the charge may be considered as referring to the old firm

and the new firm, thus debiting the liability existing at the date of the change to the old partners and crediting it to the new. The fact that the *personnel* is unchanged is immaterial.

Illustration. If on 1st January, 1953, A and C partners agreed to share profits and losses equally the adjustments would be—

Debit A ¾ × £8,500	£6,375	Credit A ½ × £8,500	£4,250
,, C ¼ × £8,500	£2,125	,, C ½ × £8,500	£4,250

or, more shortly—

Debit A	£2,125	Credit C	£2,125

As already mentioned, the principle dealt with under the heading of undisclosed assets is equally applicable to the treatment of annuities where the liability is not shown in the books, the entries being converse.

Illustration. The foregoing adjustments would be dealt with, if the Revaluation method was adopted, thus—

Dr. REVALUATION ACCOUNT *Cr.*

		£	s.	d.			£	s.	d.
To Annuity Revaluation	c/d	8,500	0	0	By A ¾		6,375	0	0
					,, C ¼		2,125	0	0
		£8,500	0	0			£8,500	0	0
To A ½		4,250	0	0	By Annuity Revaluation	b/d	8,500	0	0
,, C ½		4,250	0	0					
		£8,500	0	0			£8,500	0	0

Having adjusted the position at date of the change, admission, and/or retirement, the payments are debited to Profit and Loss Account, Drawings, Current or Reserve Account, and when the annuitant dies there will be no further entry.

The above adjustments predicate the use of methods 1–4.

Where the Annuity Suspense Account is employed, normally there will be no adjusting entries in respect of any change as the liability for the annuity is recorded. If the balance of the above account be *incorrect* it will be adjusted as a gain or loss as the case may be.

Purchase of an Annuity.[1] It has been assumed that in purchasing an annuity the cost will be precisely equal to the balance of the retired partner's capital; actually, this is by no means necessarily the position; the cost may be either more or less. Ordinarily, such difference in cost is dealt with by means of an adjustment for or against the remaining partners (unless the retired partner by agreement adjusts the difference by the payment or withdrawal of cash).

There is an alternative interpretation which is of importance in

[1] There is generally no point in purchasing an annuity, as if this is done there will be a depletion of so much of the firm's assets equal to or approximating to the liability to the outgoing (or the estate of the deceased) partner.

examination work, viz. (illustrating the position in reference to a retired partner receiving an annuity) where the capitalized value of the annuity is LESS than the balance due to him. In such a case the diminution in value may be reflective of his share of a total diminution of capital necessitating, not a debit to the retired partner and a credit to the remaining partners, but a debit to the retired partner, and ALSO a debit to the remaining partners, and a credit to the assets and/or liabilities. The converse position would arise where the capitalized value of the annuity was in EXCESS of the balance due to the retired partner, and might be interpreted as measuring the share of goodwill payable to him.

Illustration. A, B, and C were partners sharing profits and losses in the ratio of 3: 4: 1. On 1st Jan., 1953, B retired and agreed to be paid an annuity of £500 which is capitalized at £10,200. Capitals as per book values including profits less drawings to date were A £6,000, B £9,000, and C £2,000. B is to have as his share of goodwill three-fifths of the average profits of the last three years. The profits were £1,500, £3,500, and £2,500; no amount for goodwill exists in the books.

An Annuity Suspense Account is to be created.

You are required to show the Capital Accounts of the partners, together with the computation for the ascertainment of goodwill.

Note (1). The goodwill calculation is as follows—

$$\text{B's share} = \tfrac{3}{5} \times \left[\frac{1{,}500 + 3{,}500 + 2{,}500}{3}\right]$$

$$= \tfrac{3}{5} \times \frac{7{,}500}{3} = \underline{£1{,}500}$$

Therefore the WHOLE goodwill = $\frac{8}{4}$ × £1,500 = £3,000.

The calculation of goodwill of the firm must not be $\frac{5}{3}$ × £1,500 because once having found B's *share*, the basis of arriving at such share may be now ignored. As B is entitled to $\frac{4}{8}$ of the goodwill, such proportion being valued at £1,500, the whole goodwill must be double the latter sum, i.e. £3,000. Therefore, Goodwill Account is debited with £3,000 and the partners credited with their due proportions.

(2) As B's annuity is capitalized at £300 less than the balance of his account which difference is not to be given to him in cash, his loss is £300, which may be a "personal" affair whereby B is debited with £300 and A credited with $\frac{3}{4}$ × £300 = £225, and B $\frac{1}{4}$ × £300 = £75: or it may be presumed in absence of guidance in the question to represent B's share of loss on revaluation; therefore the whole loss is £600 [i.e. $\frac{8}{4}$ × £300] which is debited to the partners and credited to a Depreciation Account or specifically to assets.

The balance of Capitals is now £9,200 made up of—

		£
Capitals at 1st Jan., 1953, per books . .		17,000
Add Goodwill		3,000
		20,000
Less Loss on Revaluation .	£600	
,, Annuity Suspense . .	10,200	10,800
Revised Capitals		£9,200

If the continuing partners (i.e. A and C) desire to delete from the books the items of Goodwill and Annuity Suspense, the consequent entries will be—

Debit Annuity Suspense £10,200	Credit Goodwill		£3,000
	,,	A $\frac{3}{4} \times$ £7,200	£5,400
	,,	C $\frac{1}{4} \times$ £7,200	£1,800

Dr. CAPITALS *Cr.*

			A	B	C				A	B	C
			£	£	£				£	£	£
1953 Jan. 1	To Annuity Suspense Account			10,200		1953 Jan. 1	By Balances	b/d	6,000	9,000	2,000
	,, Loss on Revaluation of Assets (2)		225	300	75		,, Goodwill (1)		1,125	1,500	375
	,, Balances	c/d	6,900		2,300						
			£7,125	£10,500	£2,375				£7,125	£10,500	£2,375
						Jan. 2	By Balances	b/d	6,900		2,300

If on 2nd January, 1953, a new partner X was introduced, to have a quarter share (A and C ratios to remain unchanged as between themselves), the necessary entries will be—

(1) If the undisclosed items are to be permanently shown in the books (to cancel the previous elimination)—

Debit Goodwill		£3,000	Credit Annuity Suspense £10,200
,,	A $\frac{3}{4} \times$ £7,200	£5,400	
,,	C $\frac{1}{4} \times$ £7,200	£1,800	

(2) If the undisclosed items are not to be permanently shown in the books—

(*a*) As (1) above

(*b*) Debit Annuity Suspense £10,200	Credit Goodwill		£3,000
	,,	A $\frac{9}{16} \times$ £7,200	£4,050
	,,	C $\frac{3}{16} \times$ £7,200	£1,350
	,,	X $\frac{4}{16} \times$ £7,200	£1,800

SECTION (H) DISSOLUTION

When a partnership ceases to exist it is said to be dissolved. It may be so occasioned by the retirement or death of a partner notwithstanding a new agreement for the remaining partners to continue the business, but the term is usually employed to signify (1) that the partnership business has come to an end, resulting in the assets being sold separately, or taken over as a whole: or (2) that the partners are henceforth to carry on business separately, one or more taking over certain assets and liabilities. The position arising when one partner takes over the business may be dealt with on the lines applicable to the retirement of one partner, or as a sale,

as laid down in this chapter. On dissolution the following book-keeping procedure is usually followed—

A. (1) Assets (other than cash and bank) are transferred to a Realization Account, by debiting the latter account and crediting the assets.[1]

(2) Expenses of realization are debited to Realization Account and credited to cash or bank; and conversely for gains.

(3) Credit balances not being creditors or debts due to partners, e.g. Bad Debts Provision. Debit the particular credit balance and credit Realization Account.

(4) On sale of the business or individual assets. Debit cash (or particular asset received, e.g. shares) or purchaser and credit Realization Account. If the purchaser is a partner his account will be debited.

(5) The balance of Realization Account is closed in the same manner as the ordinary Profit and Loss Account, that is—

(*a*) If a profit, debit Realization Account and credit Partners' Capital Accounts.

(*b*) If a loss, debit Partners' Capital Accounts and credit Realization Account.

(6) If the creditors of the firm are paid off by the firm, debit creditors, credit cash or bank; but if taken over they will be credited to the Realization Account.

(7) The partners are next paid in respect of advances, the entry being: debit Partner's Advance Account, credit cash, unless his Capital and/or Current Accounts are in debit when a transfer will be made to clear it (them) if the credit or advance account is sufficient. The remaining balance on advance account (if any) will then be paid.

(8) The various Partners' Accounts, e.g. Current and Capital Accounts, are merged and the balance of the combined or merged account inclusive of the transfer made under heading (5) will equal the remaining cash (or shares).

(9) The cash (or shares) are paid in discharge of the final balances due to partners by debiting Partners' Accounts and crediting cash (or shares).

(10) If one of the partners as a result of realization is in debit, he will either bring in cash or his account will, to the extent that he cannot bring in cash, be written off against the other solvent partners in their *capital* ratios. (*Garner* v. *Murray*, see page 721.)

B. Alternatively to (1). Each asset may be taken as a separate Sub-realization Account, that is, the amount realized is credited to such asset, the profit or loss being transferred, as the case may be, to the credit or debit of Realization Account; e.g. if the asset were fixtures in the books at £120, and realized £100, the latter

[1] Debtors will be debited "gross" (i.e. per Sales Ledger) and not "net." Where a Bad Debt Provision exists, it is transferred to the credit of Realization Account.

would be debited to cash and credited to the Fixtures Account, and the remaining balance of £20 transferred by debiting Realization Account and crediting Fixtures Account.

Illustration. The following is the Balance Sheet of A and B who share profits and losses in the ratio 3 : 2.

BALANCE SHEET

		£		£
Creditors		400	Cash	100
Loan— A		50	Debtors	1,800
Capitals—			Stock	150
A	£900			
B	700			
		1,600		
		£2,050		£2,050

They decide to go out of business; the debtors realize £1,430 and stock £180. Expenses of realization £20. Show closing accounts.

Method A.

Dr. REALIZATION ACCOUNT Cr.

		£			£
To Debtors		1,800	By Cash—		
„ Stock		150	Debtors		1,430
„ Expenses of Realization		20	Stock		180
			„ Balance: Loss—		
			A: $\frac{3}{5}$	£216	
			B: $\frac{2}{5}$	144	
					360
		£1,970			£1,970

Dr. CASH Cr.

		£			£
To Balance	b/d	100	By Expenses of Realization		20
„ Debtors		1,430	„ Creditors		400
„ Stock		180	„ A Loan		50
			„ Balance—		
			A	£684	
			B	556	
					1,240
		£1,710			£1,710

Dr. DEBTORS Cr.

		£		£
To Balances	b/d	1,800	By Realization Account	1,800

Dr. STOCK Cr.

		£		£
To Balance	b/d	150	By Realization Account	150

Dr. **Capitals** *Cr.*

		A	B			A	B
		£	£			£	£
To Realization Account–Loss		216	144	By Balances . .	b/d	900	700
„ Cash . .		684	556				
		£900	£700			£900	£700

Dr. **Creditors** *Cr.*

		£			£
To Realization Account .		400	By Balances . . .	b/d	400

Dr. **A Loan** *Cr.*

		£			£
To Cash		50	By Balance . . .	b/d	50

Method B.

Dr. **Realization Account** *Cr.*

		£			£
To Debtors: Loss on Realization . . .		370	By Stock: Profit on Realization		30
„ Expenses of Realization .		20	„ Balance: Loss—		
			A $\frac{3}{5}$ . . .	£216	
			B $\frac{2}{5}$ . . .	144	360
		£390			£390

Dr. **Cash** *Cr.*

		£			£
To Balance	b/d	100	By Expenses of Realization .		20
„ Debtors . . .		1,430	„ Creditors . . .		400
„ Stock		180	„ A Loan Account . .		50
			„ Balance—		
			A . . .	£684	
			B . . .	556	1,240
		£1,710			£1,710

Dr. **Debtors** *Cr.*

		£			£
To Balances . . .	b/d	1,800	By Cash		1,430
			„ Balance to Realization Account . .		370
		£1,800			£1,800

Dr. STOCK *Cr.*

To Balance . . .	b/d	£ 150	By Cash		£ 180
Realization Account .		30			
		£180			£180

Dr. CAPITALS *Cr.*

		A	B			A	B
		£	£			£	£
To Realization Account–Loss		216	144	By Balances . .	b/d	900	700
„ Cash . .		684	556				
		£900	£700			£900	£700

Dr. CREDITORS *Cr.*

To Realization Account .		£ 400	By Balances . . .	b/d	£ 400

Dr. A LOAN *Cr.*

To Cash		£ 50	By Balance . . .	b/d	£ 50

Illustration. The assets of A, B and C sharing profits and losses, 3 : 1 : 1, are £1,400, liabilities £500, and capitals, A £500, B £300, and C £100.

The assets realize £400. Ignoring expenses, show accounts assuming all partners are insolvent.

Dr. REALIZATION ACCOUNT *Cr.*

To Sundry Assets . .		£ 1,400	By Cash		£ 400
			„ Loss transferred to Capital Adjustment Account . . .		1,000
		£1,400			£1,400

Dr. CREDITORS *Cr.*

To Cash		£ 400	By Balances . . .	b/d	£ 500
„ Balance transferred to Capital Adjustment Account . .		100			
		£500			£500

Dr. CASH *Cr.*

		£			£
To Realization Account .		400	By Creditors, Payment of 16s. in £ . . .		400
		£400			£400

Dr. CAPITAL ADJUSTMENT ACCOUNT *Cr.*

		£			£
To Loss on Realization .		1,000	By Creditors . . .		100
			,, Loss transferred—		
			A . . .	£540	
			B . . .	180	
			C . . .	180	
					900
		£1,000			£1,000

Dr. CAPITALS *Cr.*

		A	B	C				A	B	C
		£	£	£				£	£	£
To Loss . .		540	180	180		By Balances .	b/d	500	300	100
,, Balance transferred from A and C . .			120			,, Balance transferred to B		40		80
		£540	£300	£180				£540	£300	£180

Note. As the Capital Accounts of A and C are both overdrawn the whole of the loss must be borne by B.

It should be clearly appreciated that the mere fact that a partner is insolvent does not necessarily justify an inference that he can contribute nothing at all.

As the creditors are still entitled to a further 4s. in the £ those partners (if any) who are able to contribute any sum will be required to do so in profit and loss ratio, and even then whatever amounts still remain unpaid can be claimed from *any* individual partner.

Illustration. Q, S, and O, partners, share profits and losses as to 2 : 2 : 1. Their Balance Sheet at 31st December, 19.., is as follows—

Q, S, AND O BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£	£		£	£
Creditors . . .		2,000	Cash . . .		2,000
Capitals—			Sundry Debtors. .	1,300	
Q . .	5,000		*Less* Bad Debts Provision . .	300	
S . .	2,000				1,000
O . .	1,000				
		8,000	Stock . . .		2,000
			Fixtures and other Assets . . .		5,000
	£	10,000		£	10,000

The following are the amounts realized—

	£
Fixtures and other Assets	4,500
Stock	2,260
Debtors	900

	£
Creditors paid in complete discharge	1,900
Expenses of Realization	60

Show Accounts (using Method A).

Dr. CASH *Cr.*

		£			£
To Balance	b/d	2,000	By Realization Account—Expenses of Realization[1]		60
,, Realization Account—Assets realized:			,, Creditors		1,900
Stock		2,260	,, Capital Accounts—		
Debtors		900	Q . . £4,880		
Fixtures and other Assets		4,500	S . . 1,880		
			O . . 940		7,700
		£9,660			£9,660

Dr. DEBTORS *Cr.*

		£			£
To Balances	b/d	1,300	By Realization Account		1,300

Dr. STOCK *Cr.*

		£			£
To Balance	b/d	2,000	By Realization Account		2,000

Dr. FIXTURES (AND OTHER ASSETS) *Cr.*

		£			£
To Balances	b/d	5,000	By Realization Account		5,000

Dr. BAD DEBTS PROVISION *Cr.*

		£			£
To Realization Account		300	By Balance	b/d	300

Dr. CREDITORS *Cr.*

		£			£
To Cash		1,900	By Balances	b/d	2,000
,, Realization Account		100			
		£2,000			£2,000

[1] The entries should be made in this order; repayments of advances by partners (if any) would be shown after creditors and before repayments of Capital Accounts.

Dr. CAPITALS *Cr.*

		Q	S	O			Q	S	O
		£	£	£			£	£	£
To Loss on Realization		120	120	60	By Balances	b/d	5,000	2,000	1,000
,, Cash—Balance of Capitals.		4,880	1,880	940					
		£5,000	£2,000	£1,000			£5,000	£2,000	£1,000

Dr. REALIZATION ACCOUNT *Cr.*

		£			£
To Debtors		1,300	By Bad Debts Provision		300
,, Stock		2,000	,, Cash: Assets realized—		
,, Fixtures (and other Assets)		5,000	Stock . . £2,260		
,, Expenses of Realization		60	Debtors . 900		
			Fixtures (and other Assets) 4,500		7,660
			,, Discounts Received		100
			,, Loss on Realization—		
			Q: 2/5 . . £120		
			S: 2/5 . . 120		
			O: 1/5 . . 60		300
		£8,360			£8,360

Note. The actual transfers would (except for the purely cash transactions) be journalized, e.g. the transfers to Realization Account would be—

JOURNAL

			£	£
	Realization Account . . . . *Dr.*		8,300	
	To Debtors			1,300
	,, Stock			2,000
	,, Fixtures (and other Assets) . .			5,000
	Being Assets transferred to Realization Account			
			£8,300	£8,300

Partners Taking Over Assets and Liabilities on Dissolution. Where a partner takes over assets and/or liabilities upon dissolution the entries are—

(1) On taking over Assets—
Debit Partner's Capital Account — Credit Realization (or Dissolution) Account

(2) On taking over liabilities—
Debit Realization (or Dissolution) Account — Credit Partner's Capital Account

In the ordinary course of events no cash will be received or paid in respect of the foregoing transactions as they will

merely decrease or increase the final amount due to the partner in question.

The term "dissolution" is usually employed in reference to profits and losses upon the dissolution of a partnership where no actual realizations take place.

It will readily be observed that the partnership as a whole will reap a profit (or suffer a loss) by reason of the difference in the book value and the amount debited to the purchasing partner in respect of an asset the latter acquires, such partner being credited (or debited) with his due proportion of such profit (or loss).

Assets sold will be dealt with in the normal way so that the final balance in the bank, that is the balance (unless taken over by a partner) at the date of the dissolution, together with cash realizations less expenses, will be equal to the final balance of the partners' Capital Accounts.

Illustration. A, B, and C sharing profits 3 : 1 : 1 agree upon dissolution. They each decide to take over certain assets and liabilities and continue business separately.

BALANCE SHEET AS AT 31ST DECEMBER, 19.. (DATE OF DISSOLUTION)

	£	£		£	£
Creditors		600	Cash		320
Loan		150	Sundry Assets		1,700
Capitals—			Debtors	2,420	
A	2,750		*Less* Bad Debts Provision	120	
B	1,000				2,300
C	700				
		4,450	Stock		780
			Fixtures		100
		£5,200			£5,200

It is agreed as follows—

(1) Goodwill is to be ignored.

(2) A is to take over all the fixtures at £80; debtors amounting to £2,000 at £1,720. The creditors of £600 to be assumed by A at that figure.

(3) B is to take over all the stock at £700 and certain of the sundry assets at £720 (being book values, less 10 per cent).

(4) C is to take over the remaining sundry assets at 90 per cent of book values less £10 allowances and assume responsibility for the discharge of the loan, together with accruing interest of £3 which has not been recorded in the books of the firm.

(5) The expenses of dissolution were £27. The remaining debtors were sold to a debt collecting agency for 50 per cent of book values.

Prepare accounts.

Dr. **Dissolution Account** *Cr.*

	£	£		£	£
To Assets (except Cash)		5,000	By Bad Debt Provision		120
,, Expenses of Dissolution		27	,, Assets taken over—		
,, Loan Interest		3	A: Fixtures £80		
			Debtors 1,720	1,800	
			B: Stock £700		
			Sundry Assets 720	1,420	
			C: Sundry Assets	800	4,020
			,, Cash: Sale of Debtors		210
			,, Loss on Dissolution:		
			A: $\frac{3}{5}$	408	
			B: $\frac{1}{5}$	136	
			C: $\frac{1}{5}$	136	680
		£5,030			£5,030

Dr. **Capitals** *Cr.*

		A	B	C			A	B	C
		£	£	£			£	£	£
To Assets taken over (per Dissolution Account)		1,800	1,420	800	By Balances	b/d	2,750	1,000	700
,, Loss on Dissolution		408	136	136	,, Liabilities taken over		600		
,, Balance	c/d	1,142			,, Loan taken over				153
					,, Balances	c/d		556	83
		£3,350	£1,556	£936			£3,350	£1,556	£936
To Balances	b/d		556	83	By Balance	b/d	1,142		
,, *Cash*		*1,142*			,, *Cash*			*556*	*83*

Dr. **Cash** *Cr.*

		£			£
To Balance	b/d	320	By Expenses of Dissolution		27
,, Sale of Debtors		210	,, Balance	c/d	503
		£530			£530
To Balance	b/d	503	*By A*		*1,142*
,, *B*		*556*			
,, *C*		*83*			
		£1,142			*£1,142*

Dr. **Loan** *Cr.*

		£			£
To Transfer to C		153	By Balance	b/d	150
			,, Dissolution Account: Loan Interest		3
		£153			£153

Dr.		CREDITORS			*Cr.*
		£			£
To Transfer to A		600	By Balances	b/d	600

Notes. It is assumed that the usual novation contracts have been made.

The loan interest is not, strictly, a loss on dissolution and should be adjusted direct to the Capital Accounts, but so long as the matter is noted at the foot of the answer the treatment above is in order, particularly so as the division of £3 into fifths (and similarly with the item of £27) would involve introducing shillings and pence.

The items in italics comprise the final settlement. The Creditors' Account is shown, but this account need not be opened, the £600 being placed DIRECT to the credit of A.

The loss on dissolution may be proved as follows—

	£	£
Loss on Fixtures	20	
,, ,, Stock	80	
,, ,, Sundry Assets	180	
,, ,, Debtors[1]	370	
		650
Expenses of Dissolution	27	
Loan Interest	3	
		30
		£680

Examination Problem. Old, Middle, and Young, are in partnership as accountants carrying on practices at Brighton and Eastbourne, and sharing profits in the proportion of 7, 6, and 5 respectively. Interest at the rate of 5 per cent per annum is allowed on Capital Accounts. They decide to dissolve.

The terms of dissolution were as follows—

(*a*) Old to retire from business, his share of goodwill being valued at £3,300 to be paid by Middle and Young in the ratio in which they had been sharing profits.

(*b*) Middle to carry on business at Brighton, taking over at book values furniture and debtors in Brighton, and all liabilities; he also has to pay £600 for the lease of the Brighton office which he kept on.

(*c*) Young to take over the furniture and debtors at Eastbourne.

(*d*) Middle and Young each to be credited with 2 per cent of the amount of the book debts taken over by them respectively by way of an allowance to cover the cost of collection.

(*e*) Each partner to take over a third of the cash balance and to pay his own costs in connection with the dissolution.

[1] As the book value of debtors is £2,420 there is a loss of £280 upon the transfer to A as he takes over £2,000 debtors for £1,720. The remaining debtors are, therefore, £420 [£2,420 − £2,000] which are sold for £210, being 50 per cent of their book values; hence, the loss in this connection is £490 made up of £280 and £210. Against this sum there exists a provision of £120, leaving a final loss of £370.

The following Trial Balance was extracted from the firm's books as on 30th June, 19.., on which date the partnership was dissolved by agreement—

TRIAL BALANCE	Dr.	Cr.
	£	£
Capitals as at 1st July, 19..—		
Old		4,000
Middle		4,000
Young		3,000
Drawings—		
Old	1,573	
Middle	1,292	
Young	816	
Goodwill	2,400	
Sundry Creditors		78
Cash	318	
Profit and Loss Account for the year to 30th June, 19.. (before charging Interest)		5,716
Sundry Debtors—		
Brighton	6,750	
Eastbourne	3,150	
Furniture—		
Brighton	320	
Eastbourne	175	
	£16,794	£16,794

You are required to close the books of the firm, assuming that Middle and Young each settled his liability by paying a cheque to Old on 30th September. Interest after 30th June to be ignored.

(*Institute of Chartered Accountants Final.*)

Dr. DISSOLUTION ACCOUNT Cr.

19..			£	19..			£
June 30	To Goodwill*		2,400	June 30	By Middle—		
	" Debtors		9,900		Lease		600
	" Furniture		495		Debtors		6,750
	" Allowance on Debtors—				Furniture		320
	Middle		135		" Young—		
	Young		63		Debtors		3,150
					Furniture		175
					" Loss transferred—		
					Old: $\frac{7}{18}$	£777	
					Middle: $\frac{6}{18}$	666	
					Young: $\frac{5}{18}$	555	
							1,998
		£	12,993			£	12,993

* A further alternative is to increase the goodwill from £2,400 to £8,485 (i.e. not to write the £2,400 off to Dissolution Account) and to credit the partners with their due proportion of the resultant increase, and to debit Middle and Young with the whole of the goodwill as revalued. (See page 720.)

Dr. **CAPITALS** *Cr.*

		Old	Middle	Young				Old	Middle	Young
19..		£	£	£	19..			£	£	£
June 30	To Drawings . .	1,573	1,292	816	July 1	By Balances . .	b/d	4,000	4,000	3,000
	,, Debtors . .		6,750	3,150	19..					
	,, Furniture . .		320	175	June 30	,, Interest on Capital .		200	200	150
	,, Lease . . .		600			,, Profit . . .		2,009	1,722	1,435
	,, Goodwill—Old[1] .		1,800	1,500		,, Allowance on Debtors . . .			135	63
	,, Dissolution Account	777	666	555		,, Goodwill—Middle and Young[1] .		3,300		
	,, Cash . . .	106	106	106		,, Liabilities taken over			78	
Sept. 30	,, Cash from Middle and Young .	(a)7,053			Sept. 30	,, Cash to Old . .			(a)5,399	(a)1,654
		£9,509	£11,534	£6,302				£9,509	£11,534	£6,302

[1] See statement at top of page 721. Alternatively, the whole Goodwill could be raised to the full after writing out the old book value, viz. $\frac{18}{7} \times$ £3,300 = £8,485 dealt with as follows—

GOODWILL STATEMENT

	Old	Middle	Young	Total
	£	£	£	£
Credited	$\frac{7}{18}$ 3,300	$\frac{6}{18}$ 2,828	$\frac{5}{18}$ 2,357	8,485 (*Dr.* Goodwill)
Upon Reversal, debited .		$\frac{6}{11}$ 4,628	$\frac{5}{11}$ 3,857	8,485 (*Cr.* Goodwill)
	+ £3,300	− £1,800	− £1,500	—

(*a*) These items are the only cash items, seeing that the cash balance at the date of dissolution is taken out by the partners in equal proportions.

GOODWILL STATEMENT

		Old	Middle	Young	Total
		£	£	£	£
Increase in value of Goodwill (7 : 6 : 5)	Cr.	2,366	2,028	1,691	6,085
Goodwill written back (6 : 5)	Dr.		4,628	3,857	8,485
Net Adjustment	[1]Dr.	+ 2,366	− 2,600	− 2,166	− 2,400
Goodwill £2,400 already in books (7 : 6 : 5)		+ 934	+ 800	+ 666	+ 2,400
Net + or − per page 720		+£3,300	− £1,800	− £1,500	—

Garner v. Murray. The principle laid down in *Garner* v. *Murray* is that where, upon dissolution, a partner's Capital Account is in debit and the partner is unable to contribute the full deficiency, the loss must be divided amongst the Solvent partners in the ratio of their *last agreed* capitals. The correctness of this decision has been the subject of much criticism, and it is now customary expressly to exclude the rule in partnership agreements.

The Procedure. When *Garner* v. *Murray* has to be applied the Realization Account is dealt with in the usual way and the profit or loss on realization divided amongst the partners in their ordinary profit or loss sharing ratio. If, after this division, there is a debit balance on one of the partner's capital accounts, the partner must pay in as much of this as he is able, and the balance, if any, which is a loss, must be divided amongst the remaining partners in the ratio of their last agreed capitals. It will be observed that the operation of *Garner* v. *Murray* applies *after* the profit or loss on realization has been recorded in the normal manner. Theoretically, the solvent partners should PAY cash into the firm to the extent of any loss on Realization Account, but as this would merely increase their capitals and the amount be automatically repaid in the final settlement, the cash contribution in respect of the loss is not usually made, but merely brought into account.

As the liability of the solvent partners is based upon their last *agreed* capitals, it is important to remember that such agreed capitals may have arisen through a "course of dealing."

Illustration. A, B, and C are in partnership, sharing profits and losses equally. Their capital accounts are A, *Cr.* £6,000; B, *Cr.* £4,000; and C, *Dr.* £300.

They dissolve partnership and a loss of £900 is incurred on realization, and C is insolvent, being unable to contribute anything towards his deficiency.

Show the partners' Capital Accounts.

[1] The above transfers eliminate the asset Goodwill, £2,400.

Dr. CAPITALS *Cr.*

		A	B	C			A	B	C
		£	£	£			£	£	£
To Balance .	b/d			300	By Balances .	b/d	6,000	4,000	
,, Loss on Realization .		300	300	300	,, *Transfer*—				
,, *Transfer* C[1].		*360*	*240*		*A* $\frac{6}{10}$ × £600[1] .				*360*
,, Balances .	c/d	5,340	3,460		*B* $\frac{4}{10}$ × £600[1] .				*240*
		£6,000	£4,000	£600			£6,000	£4,000	£600
					By Balances .	b/d	5,340	3,460	

The problem is not involved; it merely requires that C's deficiency is to be debited to A and B in the ratio of 3 : 2 instead of equally, and obviously the question of the DIVISION of the loss between A and B does not affect C's account at all; whether the loss is charged to A and B equally, or in any other ratio has no bearing on the fact that C's account must be credited with £600. The loss to A and B, but for *Garner* v. *Murray*, would have been £300 each, so that as a result of the decision B gains £60 at A's expense.

Illustration. Q, S, and O are in partnership sharing profits and losses 4 : 3 : 1. They decide to dissolve partnership. During the dissolution O is adjudicated bankrupt and can pay only 10s. in the £. The original capitals were Q, £4,000; S, £3,000; and O, £1,000; but by agreement amongst the partners the drawings had been merged in the capital accounts and the balances at the date of dissolution were as shown in the following Balance Sheet.

Q, S, AND O, BALANCE SHEET AS AT ...

		£		£
Capitals—			Land and Buildings . .	4,000
Q . .	£6,000		Plant and Machinery .	2,500
S . .	1,500		Stock	800
		7,500	Debtors	1,400
Sundry Creditors . .		2,500	Cash	300
			O, Capital overdrawn .	1,000
		£10,000		£10,000

The assets are realized as follows—

	£
Land and Buildings	3,000
Plant and Machinery	2,000
Stock	900
Sundry Debtors	1,350

Five per cent discount is allowed by creditors and a contingent liability of £165 matures. The expenses of realization are £110.

[1] Per *Garner* v. *Murray*.

Show accounts, assuming that the loss or profit on realization of each asset is separately transferred from the Asset Accounts.

Dr. REALIZATION ACCOUNT *Cr.*

		£				£
To Losses—			By Profits—			
Land and Buildings		1,000	Stock			100
Plant and Machinery		500	Discount Received			125
Debtors		50	,, Loss on Realization:			
,, Contingent Liability matured		165	Q: 4/8	£800		
,, Expenses		110	S: 3/8	600		
			O: 1/8	200		
						1,600
		£1,825				£1,825

Dr. CASH *Cr.*

		£			£
To Balance	b/d	300	By Expenses of Realization		110
,, Land and Buildings	(a)	3,000	,, Creditors		2,375
,, Plant and Machinery	(a)	2,000	,, Contingent Liability paid		165
,, Stock	(a)	900	,, Capitals—		
,, Debtors	(a)	1,350	Q		4,720
,, Dividend: O		600	S		780
		£8,150			£8,150

(*a*) In examination work the four items may be entered in one figure thus: Assets realized per question, £7,250.

Dr. CAPITALS *Cr.*

		Q	S	O			Q	S	O
		£	£	£			£	£	£
To Balance	b/d			1,000	By Balances	b/d	6,000	1,500	
,, Loss on Realization		800	600	200	,, Dividend of 10s. in £				600
,, Transfer: Loss on O deficiency per *Garner* v. *Murray*		480	120		,, Transfer to Q: [60/75 × £600]				480
,, Cash		4,720	780		S: [15/75 × £600]				120
		£6,000	£1,500	£1,200			£6,000	£1,500	£1,200

The Ledger Accounts need not be given unless specifically required, but it is advisable to submit a "sample" thus—

Dr. LAND AND BUILDINGS *Cr.*

		£			£
To Balance		4,000	By Cash		3,000
			,, Realization Account: Loss		1,000
		£4,000			£4,000

That the decision in *Garner* v. *Murray* may harshly affect a partner may be demonstrated by the following example.

Illustration. A, B, and C are partners; the partnership is dissolved; C is insolvent and unable to contribute anything in payment of his debt to the firm; B has ample private means. At the date of dissolution the following is the position—

A, B, AND C BALANCE SHEET AS AT ...

	£		£
Capital—A	2,000	Cash	600
		Capitals—	
		B	200
		C	1,200
	£2,000		£2,000

Show the partners' Capital Accounts.

Applying the rule in *Garner* v. *Murray*, the deficiency of C is to be borne by A and B in the ratio of their last agreed capitals, but A being the only person with capital in the firm will have to bear the WHOLE of such deficiency: so that notwithstanding B's comparative affluence—and quite conceivably he is much more wealthy than A—the latter must bear the entire burden merely because it so happens that B's share at the date of dissolution is overdrawn. The decision does not mean in this problem that B is able to avoid bringing cash into the firm in respect of his own debt.

Dr. CAPITALS *Cr.*

		A	B	C			A	B	C
		£	£	£			£	£	£
To Balances .	b/d		200	1,200	By Balance .	b/d	2,000		
,, Transfer from C . .		1,200			,, Transfer to A				1,200
,, Cash . .		800			,, Cash . .			200	
		£2,000	£200	£1,200			£2,000	£200	£1,200

Dr. CASH *Cr.*

		£			£
To Balance	b/d	600	By A Capital		800
,, B Capital		200			
		£800			£800

PIECEMEAL PAYMENTS

Not infrequently does it happen in dissolution that considerable difficulty is encountered in the realization of assets with the natural result that the final distribution to the partners is delayed; but circumstances may render it imperative that the partners be paid sums on account as and when received, particularly if the dissolution process is protracted. It is necessary to avoid, so far as possible, the unpleasant consequences of a partner's account at the later stages of realization being overdrawn, as it might be, if he had a

small capital with a comparatively high ratio of profit sharing and loss bearing, and were paid out on a capital basis followed by subsequent heavy losses in realization.

The principle which underlies the payments on account, always subject to any other AGREEMENT between the partners themselves, is to assume that at each stage the remaining **Unrealized** assets are WORTHLESS and the Capital Accounts adjusted accordingly, applying where compatible with the circumstances the *Garner* v. *Murray* rule; the balance of the adjusted Capital Accounts will then be the same as the amount of cash, such balance being withdrawn by partners, reducing the Capital accordingly: this process is repeated at each stage and for the purpose of distribution the remaining assets are considered worthless. It is obvious that before this state of affairs is reached current realization expenses, creditors, and advances by partners, must FIRST be paid.

Illustration. The following is the Balance Sheet of A, B, and C, sharing profits and losses 1 : 2 : 1.

BALANCE SHEET AS AT........

		£		£
Creditors		1,000	Sundry Assets . . .	6,000
Capitals—				
A . .	£2,500			
B . .	1,800			
C . .	700			
		5,000		
		£6,000		£6,000

The assets are realized piecemeal and distributions are made on account as and when realized.

The realizations are, ignoring expenses—

Realization No.	Book Value	Cash Realized	Available for Creditors	Available for Partners
	£	£	£	£
(1)	500	500[1]	500	
(2)	2,200	2,000[1] (∴ Loss £200)	500	1,500
(3)	600	600		600
(4)	1,600	1,600		1,600
(5)	1,100	1,300 (∴ Gain £200)		1,300
	£6,000	£6,000	£1,000	£5,000

Show distributions.

It will be necessary to construct a statement of Capital Accounts (preferably in tabular form), so that the resultant balances after each set of realizations are disclosed. This statement will show the basis of repayment of capital to each partner at each stage.

[1] Creditors will take the first £500 and £500 of the second realization leaving £1,500 for the partners.

Statement of Capital Accounts

	Total	A	B	C
	£	£	£	£
Balances	5,000	2,500	1,800	700
Less Loss on Realization .	200	50	100	50
	4,800	2,450	1,700	650
Less possible Loss in respect of remaining Assets of £3,300 being worthless .	3,300	825	1,650	825
	1,500	+ 1,625	+ 50	− 175
Deficiency of C's Capital written off in ratio of 25 : 18 per *Garner* v. *Murray* . .		− 102	− 73	+ 175
	1,500	+ 1,523	− 23	
Deficiency of B's Capital written off against A . .		− 23	+ 23	
Repay .	*£1,500*	*£1,500*		
Balances of Capital Accounts after Loss on Realization .	4,800	2,450	1,700	650
Less Cash (as above) .	1,500	1,500		
	3,300	950	1,700	650
As £600 is realized without loss, there is now a possibility of the remaining Assets of £2,700 being worth nil. . . .	2,700	675	1,350	675
	600	+ 275	+ 350	− 25
Deficiency of C's Capital written off in ratio of 25 : 18 per *Garner* v. *Murray* .		− 15	− 10	+ 25
Repay .	*£600*	*£260*	*£340*	
Balances of Capital Accounts after payment of £1,500 .	3,300	950	1,700	650
Less Cash (as above) .	600	260	340	
	2,700	690	1,360	650
As £1,600 is realized without loss there is now a possibility of the remaining Assets of £1,100 being worth nil . . .	1,100	275	550	275
Repay .	*£1,600*	*£415*	*£810*	*£375*
Balances of Capital Accounts after payment of £600 .	2,700	690	1,360	650
Less Cash (as above) .	1,600	415	810	375
Balances of Capital Accounts after payment of £1,600 .	1,100	275	550	275
Add Profit on Realization .	200	50	100	50
Repay .	*£1,300*	*£325*	*£650*	*£325*
Balances of Capital Account after payment of £1,300 .	nil	nil	nil	nil

Summary of distributions—

	Total	A	B	C
	£	£	£	£
First	1,500	1,500		
Second	600	260	340	
Third	1,600	415	810	375
Fourth	1,300	325	650	325
	£5,000	£2,500	£1,800	£700

This gives precisely the same result as if the assets had been realized in one sum.

Thus, the total cash paid equals their capitals because the only loss on realization (No. 2) of £200 is counterbalanced by the profit on realization (No. 5) of £200.

Alternative Method of Piecemeal Payments. Alternatively, a less severe method may be adopted by applying the same principles without the adoption of the assumption that unrealized assets are worthless. The method is to pay off first partners who have the highest RELATIVE capitals; that is, whose capitals are greatest in proportion to their profit and loss sharing ratios.

The object is to find the largest possible capitals the partners could have had if their capitals had been proportionate to profit sharing, working from the worst placed partner's *actual* capital.

The procedure is to divide each partner's capital by his profit ratio figure; the lowest capital after this division constitutes the basic capital from which the remaining hypothetical capitals are calculated.

Illustration. Using the figures in the Balance Sheet on page 725—

A, B, and C profit ratio is 1 : 2 : 1
A, B, and C capitals are £2,500, £1,800, and £700.

Applying the rule above:

$$A = £2{,}500 \div 1 = £2{,}500 \qquad B = £1{,}800 \div 2 = £900 \qquad C = £700 \div 1 = £700$$

C is thus the basic capital and the hypothetical capitals relative to profit sharing (working from C's actual capital) are £700, £1,400, and £700.

Illustration. The distributions would, using the same facts, except *ignoring* losses and profits on realization as in the preceding example, be thus—

CAPITALS

	A	B	C
Profit and Loss Ratio . . .	1	2	1
	£	£	£
Actual Capitals	2,500	1,800	700
Capitals if in "Ratio" . .	700 (1)	1,400 (2)	700 (1)
Capitals in Excess . .	1,800	400	
Capitals of A and B if in ratio as between themselves . .	200 (1)	400 (2)	
A's Final Excess Capital	£1,600		

Thus the first £1,600 (1) will be given to A
next £600 (2) will be given to A and B in the ratio of 1 : 2
balance £2,800 (3) will be given to A, B, and C in the ratio of 1 : 2 : 1

The distribution would thus be (after paying £1,000 to creditors out of the first realization of £500 and £500 from the second realization of £2,200)—

Realization No.	Cash Available	Payment No.	Total		A	B	C
	£		£	£	£	£	£
(2)	1,700	(1)	1,600	1,600	1,600		
		(2)	100	600	33	67	
(3)	600	(2)	500		167	333	
		(3)	100	2,800	25	50	25
(4)	1,600	(3)	1,600		400	800	400
(5)	1,100	(3)	1,100		275	550	275
	£5,000		£5,000	£5,000	£2,500	£1,800	£700

Illustration. If the losses and profits are considered, the distribution would be—

Realization No.	Cash Available	Payment No.	Total		A		B		C
	£		£	£	£	£	£	£	£
(2)	1,500	1	1,500	1,600		1,500			
			100		100				
(3)	600	2							
			500	600	167			333	
					—	267			
			100		33		67		
(4)	1,600	3							
			1,500	2,800	375		750		375
					—	408	—	817	
(5)	1,300	4	1,300			325		650	325
	£5,000		£5,000	£5,000		£2,500		£1,800	£700

Sale of Business to a Limited Company. Where the partnership business is sold to a Limited Company the sale price, termed the purchase consideration, may be received partly in cash and partly in shares. Usually such a consideration includes payment for goodwill with an enhanced value possibly for the other assets, thus showing a profit to the partnership over and above book values. In addition, the acquiring company may take over the liabilities if the creditors also agree. So far as the book entries are concerned the virtual cancellation of liabilities of the partnership is a profit, so that REALIZATION ACCOUNT in lieu of CASH will be credited (and liabilities debited) when this arrangement takes place. The "profit" is more apparent than real because the purchasing company will make its purchase consideration less by an amount equal to the liabilities assumed, and hence the Realization Account will be credited with a smaller figure than it otherwise would have been had the partnership *paid* its liabilities.

When all the entries relevant to the sale have been completed, the final balances will be: (1) Partners' Capital Accounts, (2) Cash, and (3) Shares. As to the division of the assets it is for the partners themselves to decide, but in the absence of agreement the fairest way is to divide the shares out first in the *same ratio as profits and losses are shared*, so as to give the partners the same right to the benefit of appreciation, and the same liability to loss by way of depreciation, in the value of the shares, or in respect of liability to calls,[1] just as if they had still remained as partnership assets; after which the cash is paid off to BALANCE the Capital Accounts. Only ONE asset out of the two (i.e. shares and cash) is capable of being dealt with in profit and loss ratio, unless the balances of Capital Accounts before any transfer of shares or payment of cash are ALSO in profit and loss ratio. This topic is dealt with in more detail in Chapter XXIII.

If an indivisible asset (e.g. Property) remains unrealized and it is agreed to close off the partnership, the value thereof may be debited to the partners in the profit ratios; or the value counted as nil (and the partners debited with the book loss in the profit ratios) and when the asset is sold proceeds paid to the partners in the profit ratios, whether the sum realized involves a gain or loss on the book value before writing it down to nil. The payments so made will not involve any entries in the old partnership books (if still existing) except by way of memorandum.

Unless otherwise agreed, the current market valuation of the shares will be taken as the basis of division.

If it so happens that a partner's balance of capital is small but his profit and loss ratio is large, he must be content with a sufficient number of shares to clear his account (and will receive

[1] Strictly, the contribution for calls if the shares were still partnership assets would not be in profit ratios, but out of the firm's cash; but any loss or profit arising on sale would be rateable to the profit ratios.

no cash) or if he is desirous of having his "quota" of shares corresponding with his profit and loss ratio he must contribute to the firm sufficient cash to make up the difference.

Illustration. Q, S, and O, partners, share profits and losses in the ratio of 3 : 2 : 1. Their Balance Sheet at 31st December, 19.., is—

Q, S, AND O BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£	£		£	£
Capitals—			Sundry Assets . .		21,300
Q . .	11,000		Debtors . . .	6,000	
S . .	6,000		*Less* Bad Debts Provision . .	600	
O . .	4,000				
		21,000			5,400
Creditors . . .		6,300	Cash . . .		600
	£	27,300		£	27,300

They agree to sell their business for £27,000, payable £3,000 in cash; balance in shares worth £1 each; creditors are taken over by the purchasing company. Date of sale is 1st January, 19...

Show Accounts, ignoring expenses of realization.

The accounts are (proceeding direct to Realization Account)—

Dr. REALIZATION ACCOUNT *Cr.*

			£				£
19.. Jan. 1	To Sundry Assets . .		21,300	19.. Jan. 1	By Creditors . . .		6,300
	,, Debtors . . .		6,000		,, Bad Debts Provision.		600
	,, Cash[1] . . .		600		,, Purchasing Company: Purchase Consideration . . .		27,000
	,, Profit on Realization—						
	Q: 3/6 . . £3,000						
	S: 2/6 . . 2,000						
	O: 1/6 . . 1,000		6,000				
		£	33,900			£	33,900

Dr. PURCHASING COMPANY *Cr.*

			£				£
19.. Jan. 1	To Realization Account: Purchase Consideration		27,000	19.. Jan. 1	By Shares . . .	(a)	24,000
					,, Cash . . .	(b)	3,000
		£	27,000			£	27,000

Dr. CAPITALS *Cr.*

			Q	S	O				Q	S	O
			£	£	£				£	£	£
19.. Jan. 1	To Shares .	(a)[2]	12,000	8,000	4,000	19.. Jan. 1	By Balances	b/d	11,000	6,000	4,000
	,, Cash .	(b)[3]	2,000		1,000		,, Profit on Realization .		3,000	2,000	1,000
		£	14,000	£8,000	£5,000			£	14,000	£8,000	£5,000

[1] As *all* assets are taken over the cash must be handed over—it would have amounted to the same thing if the purchasing company had permitted the partners to retain the cash and reduced the cash payable from £3,000 to £2,400.

[2] Division of £24,000 worth of shares in ratio of profits 3 : 2 : 1.

[3] Cash paid to clear the accounts.

(a) and (b) The shares and cash received would be posted to the debit of the respective accounts and when transferred and paid to the partners the amounts would be credited, thus balancing both accounts.

It is important to note that the *number* of shares will not necessarily be 24,000 because the nominal value may be an amount other than £1, e.g. 10s.

Illustration. X and Y trading in partnership share profits and losses equally. On 30th September, 19.., they sold their business to P, Ltd.

Their Balance Sheet at this date was—

BALANCE SHEET AS AT 30TH SEPTEMBER, 19..

		£		£
Creditors		4,900	Sundry Assets	16,350
Capitals—			Cash	470
X	£5,280		Current Account X	500
Y	4,560			
		9,840		
Loan X		2,100		
Current Account Y		480		
		£17,320		£17,320

The purchasers agreed as follows—

(a) To pay deposit of £5,000 immediately so that the firm could discharge its liabilities.

(b) To give £3,000 for goodwill and £15,920 in cash for the remaining assets (excluding cash which is not taken over).

(c) To pay interest on the balance of purchase price at 5 per cent per annum, full completion to be made on 31st December, 19...

X and Y are to be allowed interest on their capitals at 5 per cent per annum, and X to be allowed interest on his loan at 4 per cent per annum till settlement. Ignore tax.

Show accounts in the books of the vendors.

Dr. REALIZATION ACCOUNT *Cr.*

19..			£	19..		£
Sept. 30	To Assets		16,350	Sept. 30	By P. Ltd.—	
	,, Expenses		?		Purchase Consideration	18,920
	,, Profit—					
	X	£1,285				
	Y	1,285				
			2,570			
			£ 18,920			£ 18,920

Dr. CASH *Cr.*

19..			£	19..		£
Sept. 30	To Balance	b/d	470	Sept. 30	By Expenses of Realization	?
Oct. 1	,, P., Ltd.		5,000	Oct. 1	,, Creditors	4,900
Dec. 31	,, ,, ,, : Balance		14,094	Dec. 31	,, Loan Account	2,121
					,, Capital Accounts—	
					X	6,146
					Y	6,397
			£ 19,564			£ 19,564

Dr. P, LTD. **Cr.**

19..			£	19..			£
Sept. 30	To Realization Account—Purchase Consideration . . .		18,920	Oct. 1	By Cash: (Deposit) . .		5,000
Dec. 31	,, Interest on Balance—£13,920 at 5% per annum for 3 months		174	Dec. 31	,, Cash: Balance . .		14,0[illegible]
		£	19,094			£	19,094

Dr. CAPITALS **Cr.**

			X	Y				X	Y
19..			£	£	19..			£	£
Dec. 31	To Cash . .		6,146	6,397	Sept. 30	By Balances .	b/d	*5,280*	*4,560*
						,, Current Accounts .		785	1,765
					Dec. 31	,, Interest on Capital .		66	57
						,, Interest Account—Balance .		15	15
			£6,146	£6,397				£6,146	£6,397

Dr. CURRENT ACCOUNTS **Cr.**

			X	Y				X	Y
19..			£	£	19..			£	£
Sept. 30	To Balance .	b/d	*500*		Sept. 30	By Balance .	b/d		*480*
	,, Capital Accounts .		785	1,765		,, Profit on Realization .		1,285	1,285
			£1,285	£1,765				£1,285	£1,765

Dr. X LOAN **Cr.**

19..			£	19..			£
Dec. 31	To Cash		2,121	Sept. 30	By Balance . . .	b/d	*2,100*
				Dec. 31	,, Interest on Loan .		21
			£2,121				£2,121

Dr. INTEREST **Cr.**

19..			£	19..			£
Dec. 31	To Interest on Capital— X . . £66 Y . . 57		123	Dec. 31	By P. Ltd.		174
	,, Interest on Loan X		21				
	,, Balance: Capital Accounts: X: ½ . £15 Y: ½ . 15		30				
			£174				£174

Note 1. The order of payment should be carefully observed. If the balance of Current Account of X had still remained in debit after balancing Realization Account it would have been set off against his Loan Account.

2. The items in italics (disposing of the Balance Sheet items) should FIRST be inserted so as to commence "in balance."

In a dissolution it occasionally happens that there are assets which are unrealizable or not easily realizable. The method of dealing with such assets must first depend upon the agreement between the partners; otherwise, unless the final dissolution is to be unduly delayed, such assets should where capable of division be divided in *profit* ratios, so that theoretically any profit or loss on ultimate disposal will be in profit ratios, thus putting the partners in the same position as if the firm had kept them and ultimately sold them. In fact, each ex-partner will be able to decide for himself when to sell, and his profit or loss might be much greater or less than if the firm sold them piecemeal or *in toto*. The equity of the procedure is clear because from the moment of distribution it is a matter for each ex-partner to exercise his own discretion as a personal matter.

No difficulty will generally arise with regard to shares in a Limited Company, but the firm might have other unsaleable assets which in fact cannot be divided, e.g. a building, in which case there can be no "distribution": usually, if there are non-divisible and unrealizable assets, the partners come to some arrangement as to taking them over personally at an agreed valuation. Often shares which are unsaleable will be partly paid and the division in profit ratios throws a potential liability fairly as between the parties.

Illustration. A and B who shared profits 3 : 2, are partners and the position, after realization, is—

Balance Sheet

	£		£
A	1,900	Cash	2,700
B	1,700	Shares at cost	500
		Other Assets	400
	£3,600		£3,600

It is agreed that "other assets" shall be taken over by A for £300; the Shares divided out equitably and settlement of balance in Cash. Show A's and B's accounts dealing with the above, ignoring transfer costs.

Capitals

	A	B		A	B
	£	£		£	£
To Other Assets	300		By Balances	1,900	1,700
,, Loss on Book Value of Other Assets	60	40			
,, Shares[1]	300	200			
,, Cash	1,240	1,460			
	£1,900	£1,700		£1,900	£1,700

[1] Alternatively, the shares may be written down to, say, *nil*, the loss being debited to A and B (in lieu of item shares: A, £300; and B, £200; but the net result is unaltered).

General Illustration. Barlick and Earby are partners sharing profits 3 : 2.

On the 30th June, 19.., they admit Colne as a partner, and the new profit ratio is 2 : 2 : 1. Colne brought in Fixtures £300 and Cash £1,000, the Goodwill being (*a*) Barlick and Earby £2,000 and (*b*) Colne £1,000, but neither figure is to be brought into the books.

On the 31st Dec., 19.., the partnership is dissolved, Barlick retiring and the other two partners forming a Limited Company with equal capitals, taking over all remaining assets and liabilities, Goodwill being agreed at £4,000 and brought into the books of the Limited Company. Barlick agrees to take over the business car at £370. Plant was sold for £300, being in excess of requirements. The profits of the two preceding years were £1,720 and £1,900 respectively and it was agreed that for the half-year ended 30th June, 19.., the net profit was to be taken as equal to the average of the two preceding years and the current year.

No entries had been made when Colne entered, except for Cash.

From the following Trial Balance and the information given above, show the Ledger entries in the books of the firm and the limited company, no new books being opened by the latter. There is no interest on drawings or capital. Ignore depreciation, Tax and expenses connected with the dissolution of the firm and formation of the new company. Barlick agreed to leave £5,000 on loan to the Company, secured by 6 per cent Debentures.

TRIAL BALANCE, 31ST DECEMBER, 19..

	£	£
Barlick—Drawings and Capital	600	3,500
Earby— ,, ,,	500	2,000
Colne— ,, ,,	280	1,000
Debtors	3,100	
Creditors		1,200
Plant [book value of Plant sold, £400]	2,300	
Fixtures	700	
Motor Car	270	
Stock at 31st December, 19..	1,300	
Cash at Bank	1,630	
Profit and Loss Account for year		2,980
	£10,680	£10,680

Dr. MOTOR CAR *Cr.*

			£				£
19.. Jan. 1	To Balance	b/d	270	19.. Dec. 31	By Barlick		370
Dec. 13	,, Profit on Realization		100				
			£370				£370

Dr. **Goodwill Adjustment** Cr.

		Barlick	Earby	Colne			Barlick	Earby	Colne
19..		£	£	£	19..		£	£	£
June 30	To Contra . .	(2/5) 800	(2/5) 800	(1/5) 400	June 30	By Contra . .	(3/5) 1,200	(2/5) 800	
	,, Contra . .	(1/5) 400	(2/5) 400	(1/5) 200		,, Contra . .			1,000
Dec. 31	,, Capitals .	1,600	1,200	1,200	Dec. 31	,, Goodwill .	(2/5) 1,600	(2/5) 1,600	(1/5) 800
		£2,800	£2,400	£1,800			£2,800	£2,400	£1,800

Capitals

		Barlick	Earby	Colne			Barlick	Earby	Colne
19..		£	£	£	19..		£	£	£
Dec. 31	To Cash (Drawings) .	600	500	280	Jan. 1	By Balances b/d	3,500	2,000	
	,, Car . .	370			June 30	,, Cash[1] . .			1,000
	,, Debentures .	5,000				,, Fixtures .			300
	,, Cash . .	762	758			,, Profit . .	1,320	880	
	,, Share Capital		3,134	3,134	Dec. 31	,, Profit . .	312	312	156
						,, Goodwill Adjustment .	1,600	1,200	1,200
						,, Cash . .			758
		£6,732	£4,392	£3,414			£6,732	£4,392	£3,414

[1] This item is already in the books and the debit therefor merged in the Bank balance at 31st December, 19..

Dr. PLANT **Cr.**

Date			£	Date			£
19 . Jan. 1	To Balance	b/d	2,300	19.. Dec. 31	By Cash		300
					,, Loss on Realization		100
					,, Balance	c/d	1,900
			£2,300				£2,300
19 . Jan. 1	To Balance	b/d	1,900				

Dr. FIXTURES **Cr.**

Date			£	Date			£
19 . Jan. 1	To Balance	b/d	700	19 . Dec. 31	By Balance	c/d	1,000
June 30	,, Colne		300				
			£1,000				£1,000
19.. Jan. 1	To Balance	b/d	1,000				

Dr. PROFIT AND LOSS ON REALIZATION **Cr.**

Date			£	Date			£
19.. Dec. 31	To Loss on Sale of Plant		100	19.. Dec. 31	By Profit on Sale of Car		100

Dr. GOODWILL **Cr.**

Date			£	Date			£
19.. Dec. 31	To Goodwill Adjustment Account		4,000				

Dr. PROFIT AND LOSS [APPROPRIATION] ACCOUNT **Cr.**

Date		£	£	Date			£
19.. June 30	To Barlick—$\frac{3}{5}$ [See Note 1]	1,320		19.. Dec. 31	By Balance, Net Profit	b/d	2,980
	,, Earby—$\frac{2}{5}$ [See Note 1]	880					
			2,200				
Dec. 31	,, Barlick—$\frac{2}{5}$	312					
	,, Earby—$\frac{2}{5}$	312					
	,, Colne—$\frac{1}{5}$	156					
			780				
			£2,980				£2,980

Dr. CASH **Cr.**

Date			£	Date			£
19.. Dec. 31	To Balance	b/d	1,630	19 . Dec. 31	By Barlick		762
	,, Sale of Plant		300		,, Earby (to adjust Share Capital)		758
	,, Colne (to adjust Share Capital)		758		,, Balance	c/d	1,168
			£2,688				£2,688
19 . Jan. 1	To Balance	b/d	1,168				

Dr. SIX PER CENT DEBENTURES **Cr.**

Date			£	Date			£
				19.. Dec. 31	By Barlick		5,000

Dr. SHARE CAPITAL *Cr.*

			£				£
19.. Dec. 31	To Balance	c/d	6,268	19.. Dec. 31	By Earby ,, Colne		3,134 3,134
			£6,268				£6,268
				19.. Jan. 1	By Balance	b/d	6,268

TRIAL BALANCE

	£	£
Debtors	3,100	
Creditors		1,200
Fixtures	1,000	
Plant	1,900	
Goodwill	4,000	
Cash at Bank	1,168	
Stock	1,300	
Share Capital		6,268
6% Debentures		5,000
	£12,468	£12,468

Note (1) Profit for preceding years: £1,720 + £1,900 = £3,620
Profit for current year: 2,980

3)6,600

£2,200

(2) The profit for the half year to 30th June, 19.., is *equal* to the above average and not at the annual *rate* of such profits, in which case the amount would be £1,100 only.

SECTION (I) LIMITED PARTNERSHIP

Limited Partnership.[1] Under the Limited Partnership Act, 1907, so long as there is at least one general partner who is personally liable for the obligations and liabilities of the firm, a person may become a partner in a limited sense. He is personally liable only for liabilities to the extent of his *agreed contribution, including* any withdrawal of such contribution, but beyond that is not personally liable for obligations and liabilities, however disastrously the firm's course may run. He cannot be made in any way liable to repay anything to the firm or to its creditors for such losses (unless he has withdrawn the whole or part of his contribution, in which case he is liable to that extent). Hence, the debit balance of his account for losses is

[1] In general accounting problems dealing with partnerships, it usually will be clear as to whether or not the reference is to a general or limited partnership, but problems involving general points of law and accounting may merely refer to a "partnership," and this should be construed as a reference both to general *and* limited partnerships.

nothing more than a contingent asset, something akin to Short Workings Account (dealt with in Royalties) because of the right of the firm to withhold payment of any future profits until his share thereof has been sufficient to eliminate his debit balance.

After the limited partner has withdrawn the share of profits to which he is legitimately entitled, the limited partnership has no control over such share, nor can it be taken into account in dealing with any subsequent events of the firm. Hence, if the limited partner decides to pay back (or probably merely transfer from Profit and Loss Account or his Current Account) his profits as a loan, he is entitled, after the other creditors, to claim for repayment when the term of the loan has expired, or on dissolution, whichever be the earlier, notwithstanding the fact that subsequent losses are such that his share thereof exceeds the amount of his loan. The loan is a debt due to him by the firm, just as if he had lent the money to an entirely independent concern; on the other hand, his share of subsequent losses is merely a "Debit Balance."

The vital point is that the Limited Partner is liable to refund sums withdrawn on account of *future* profits.

It will be clear that it is essential to have the following accounts relating to the limited partner quite separately recorded—

(1) Capital Account to be maintained at "contribution" amount.

(2) Loan Account (if any).

(3) Current Account, in which will be recorded profits and losses, interest and drawings. If a debit balance arises by reason of excessive withdrawals, it represents to the extent that it is due thereto a definite debt (as it is deemed to be a withdrawal of his contribution); but if the debit balance arises because of losses it is merely a debit balance, a mere contingent asset, which can be effective only in the event of future profits being of sufficient magnitude to enable the general partners to recoup the balance out of the limited partner's share of profits.

The main differences between a Limited and General Partnership are as follows—

	General	Limited
1. Registration .	Not necessary, except in certain cases, e.g. under Business Names Act, 1916.[1]	With Registrar of Companies under Limited Partnership Act, 1907, otherwise deemed to be general Partnership. Alteration of contribution of limited partner must be registered.
2. Inspection of books.	Partner may inspect, personally or by agent, books, documents, accounts, and take copies.	A limited partner may inspect, personally or by agent, books, documents, accounts, and take copies.

[1] See footnote 1 on page 766.

	General	Limited
3. Management .	Partner may take part, in absence of agreement.	Limited partners may only *advise*, not allowed to intermeddle: penalty—liable for firm's debts as a general partner while he so acts.
4. Assignment .	Partner cannot assign his position without consent, may assign his *share*, but assignee entitled during partnership to: (*a*) Receive Accounts. (*b*) Inspect the books. (*c*) But cannot interfere with management.	A limited partner may assign with consent and assignee entitled to: (*a*) Advise. (*b*) Receive accounts. (*c*) Inspect the books; but notice of assignment to be gazetted.
5. Death, Bankruptcy and Lunacy	Partnership dissolved. In case of Lunacy, other partners may apply to Court for dissolution.	Not dissolved, unless his share cannot be otherwise ascertained.
6. Charges .	Partner may charge his share, but other partners may dissolve at their option.	Limited partner may charge his share, but this gives no right to other partners to dissolve.
7. Winding up .	All partners liable for the firm's debts to the full extent of such debts.	Limited partner liable only to the amount of his agreed capital, or drawings in excess of share of profits.
8. Stamp Duty .	None.	10s. per £100 or part of £100 on capital contributed by limited partner (also £2 on registration).

Illustration. G, P and L are equal partners in a limited partnership, L being a limited partner. Their Balance Sheet at dissolution was—

	£		£
Capitals—		Sundry Assets (including Cash of £80) . .	13,580
G	3,500	Current Accounts—	
P	5,500	G	2,000
L	2,000	P	1,000
Creditors. . . .	6,380	L	800
	£17,380		£17,380

Of the balance of £800 standing to the debit of L, £250 represents drawings and £550 represents his share of trading losses.

The Sundry Assets, excluding the cash, realized 60 per cent of book values.

Close off the partnership accounts (ignore Realization Expenses).

Dr. REALIZATION ACCOUNT *Cr.*

	£			£
To Sundry Assets	13,500	By Cash		8,100
		,, Loss on Realization—		
		G	£1,800	
		P	1,800	
		L	1,800	
				5,400
	£13,500			£13,500

CAPITALS

	G.	P.	L.		G.	P.	L.
	£	£	£		£	£	£
To Current Accounts	2,000	1,000	800	By Balances b/d	3,500	5,500	2,000
,, Loss on Realization	1,800	1,800	1,800	,, Balances c/d	300		600
,, Balance c/d		2,700					
	£3,800	£5,500	£2,600		£3,800	£5,500	£2,600
To Balance b/d	300		600	By Balance b/d		2,700	
,, Transfer from L	175	175		,, Transfer of unrealizable Balance			
,, Cash		2,525		G			175
				P			175
				,, Cash	475		250
	£475	£2,700	£600		£475	£2,700	£600

Dr. CASH *Cr.*

		£		£
To Balance	b/d	80	By Creditors	6,380
,, Realization Account		8,100	,, P	2,525
,, G		475		
,, L		250		
		£8,905		£8,905

It is important in the case of a limited partner that withdrawals of capital against future profits should be shown in a separate account from his share of the firm's losses so that his position on a dissolution can be readily seen.

Illustration. Heaton and Moor are partners sharing profits 3 : 2, Moor being a limited partner. The Capitals are Heaton £7,000 and Moor £6,000.

The first year resulted in a loss of £4,500.

The Sundry Assets and Creditors at the end of the first year were £8,800 and £3,000 respectively.

Drawings were Heaton £1,500 and Moor £1,200.

(1) Show Balance Sheet of firm.

(2) Assuming the profits of the second year are £5,500 how will they be dealt with as regards Moor?

(1) BALANCE SHEET

		£			£
Capitals—			Sundry Assets . . .		8,800
Heaton .	£7,000		Current Accounts—		
			Heaton—		
Moor . .	6,000		$\frac{3}{5}$ Loss .	£2,700	
		13,000	Drawings .	1,500	
Creditors. . . .		3,000			4,200
			Moor—		
			$\frac{2}{5}$ Loss . . .		1,800
			Drawings . . .		1,200
		£16,000			£16,000

(2) Moor is entitled to £2,200, which must be first placed against the balance of his Current Account of £1,800 and £400 against his Drawings Account, leaving the latter at £800.

Illustration. Assuming that in reference to the preceding illustration, in the third year the firm incurred a loss of £13,500, Sundry Assets being £16,500 and Creditors £18,700, show the Balance Sheet of the firm.

There were no drawings in the second and third years.

BALANCE SHEET

		£			£
Capitals—			Sundry Assets		16,500
Heaton	£7,000		Current Accounts—		
Moor	6,000		Heaton:		
		13,000	Balance 1st year .	£4,200	
Creditors		18,700	Profit 2nd year .	3,300	
				900	
			Loss 3rd year .	8,100	
					9,000
			Moor:		
			Balance 1st year .	1,800	
			Profit (part) 2nd year	1,800	
			Loss 3rd year .		5,400
			Drawings:		
			Balance 1st year .	1,200	
			Profit (part) 2nd year .	400	
					800
		£31,700			£31,700

If dissolution takes place Moor is liable in full for £800, notwithstanding that he is in credit for £600 (Capital £6,000 less Current Account £5,400) which cannot be withdrawn unless the Creditors of the firm are fully discharged, inasmuch as he is a deferred Creditor; if Heaton is solvent and pays into the firm his

deficiency of £2,000 (Current Account £9,000 less Capital £7,000) and assets realize book values and creditors are paid off as far as possible the position will be—

	£		£
Heaton (£7,000 – £9,000 + £2,000) .	—	Cash (£16,500 + £2,000 – £18,500)	—
Moor (£6,000 – £5,400) . . .	600	Moor (Drawings)	800
Creditors (£18,700 – £18,500) . .	200		

Moor will be required to bring in £200 to be used in paying off the Creditors. This will reduce the debit of Moor's drawings to £600 which will be written off against his credit of £600 (Capital £6,000 – Current Account £5,400).

Illustration. F, R, and S are in partnership under the Limited Partnership Act, 1907, F and R being general partners with capitals of £4,000 and £3,000 respectively, and S, a limited partner with £1,500, his agreed contribution. At 1st January, 1950, all profits had been distributed. The ratio of profit and loss sharing is 3 : 2 : 1.

From the following details prepare partners' accounts—

Profits		Drawings F	Drawings R	Drawings S
	£	£	£	£
Year ended 31st Dec., 1950 . .	1,800	500	350	370
,, ,, ,, ,, 1951 . .	3,000	1,700	890	250
,, ,, ,, ,, 1952 *Loss* .	*1,200*	400	400	180
,, ,, ,, ,, 1953 . .	1,050	500	400	120
,, ,, ,, ,, 1954 . .	2,400	600	600	130

On 31st December, 1951, S lent £100 to the firm (out of profits) free of interest.

Dr. CAPITALS OF GENERAL PARTNERS *Cr.*

			F	R				F	R
					1950 Jan. 1	By Balances .	b/d	£ 4,000	£ 3,000

Dr. S LOAN *Cr.*

			1951 Dec. 31	By Current Account . .	£ 100

[The remaining accounts appear on pages 743–45.]

As has been seen, the debit balance on Capital Account of a limited partner will be dealt with according to whether the balance has arisen through excessive drawings or share of losses. If the balance arises by reason of excessive *drawings*, and the limited partner is unable to contribute by reason of his insolvency (unless

			F	R				F	R
			£	£				£	£
1950 Dec. 31	To Drawings		500	350	1950 Dec. 31	By Profit and Loss Account—			
	,, Balances	c/d	400	250		F. $\frac{3}{6}$ × £1,800		900	
						R. $\frac{2}{6}$ × £1,800			600
			£900	£600				£900	£600
1951 Dec. 31	To Drawings		1,700	890	1951 Jan. 1	By Balances	b/d	400	250
	,, Balances	c/d	200	360	Dec. 31	,, Profit and Loss Account—			
						F. $\frac{3}{6}$ × £3,000		1,500	
						R. $\frac{2}{6}$ × £3,000			1,000
			£1,900	£1,250				£1,900	£1,250
1952 Dec. 31	To Profit and Loss Account—				1952 Jan. 1	By Balances	b/d	200	360
	F. $\frac{3}{6}$ × £1,200		600		Dec. 31	,, Balances	c/d	800	440
	R. $\frac{2}{6}$ × £1,200			400					
	,, Drawings		400	400					
			£1,000	£800				£1,000	£800
1953 Jan. 1	To Balances	b/d	800	440	1953 Dec. 31	By Profit and Loss Account—			
Dec. 31	,, Drawings		500	400		F. $\frac{3}{6}$ × £1,050		525	
						R. $\frac{2}{6}$ × £1,050			350
						,, Balances	c/d	775	490
			£1,300	£840				£1,300	£840
1954 Jan. 1	To Balances	b/d	775	490	1954 Dec. 31	By Profit and Loss Account—			
Dec. 31	,, Drawings		600	600		F. $\frac{3}{6}$ × £2,400		1,200	
						R. $\frac{2}{6}$ × £2,400			800
						,, Balances	c/d	175	290
			£1,375	£1,090				£1,375	£1,090
1955 Jan. 1	To Balances	b/d	175	290					

Dr. CAPITAL OF LIMITED PARTNER S **Cr.**

			£				£
1950 Dec. 31	To Transfer from Current Account		70	1950 Jan. 1	By Balance	b/d	1,500
	,, Balance	c/d	1,430				
			£1,500				£1,500
1951 Dec. 31	To Balance	c/d	1,500	1951 Jan. 1	By Balance	b/d	1,430
				Dec. 31	,, Transfer from Current Account		70
			£1,500				£1,500
1952 Dec. 31	To Transfer from Current Account		100	1952 Jan 1	By Balance	b/d	1,500
	,, Balance	c/d	1,400				
			£1,500				£1,500
1953 Dec. 31	To Balance	c/d	1,455	1953 Jan. 1	By Balance	b/d	1,400
				Dec. 31	,, Transfer from Current Account		55
			£1,455				£1,455
1954 Dec. 31	To Balance	c/d	1,500	1954 Jan. 1	By Balance	b/d	1,455
				Dec 31	,, Transfer from Current Account		45
			£1,500				£1,500
				1955 Jan 1	By Balance	b/d	1,500

Current Account of Limited Partner S

Dr.					Cr.		
			£				£
1950 Dec. 31	To Drawings		370	1950 Dec. 31	By Profit and Loss Account $\frac{1}{6} \times$ £1,800		300
					,, Transfer to Capital Account		70
			£370				£370
1951 Dec. 31	To Drawings		250	1951 Dec. 31	By Profit and Loss Account $\frac{1}{6} \times$ £3,000		500
	,, Transfer to Capital Account		70				
	,, ,, Loan Account		100				
	,, Balance	c/d	80				
			£500				£500
1952 Dec. 31	To Profit and Loss Account $\frac{1}{6} \times$ £1,200		200	1952 Jan. 1	By Balance	b/d	80
	,, Drawings		180	Dec. 31	,, Transfer to Capital Account £180 − £80		100
					,, Balance	c/d	200
			£380				£380
1953 Jan. 1	To Balance		200	1953 Dec. 31	By Profit and Loss Account $\frac{1}{6} \times$ £1,050		175
Dec. 31	,, Drawings		120		,, Balance	c/d	200
	,, Transfer to Capital Account		55				
			£375				£375
1954 Jan. 1	To Balance	b/d	200	1954 Dec. 31	By Profit and Loss Account $\frac{1}{6} \times$ £2,400		400
Dec. 31	,, Drawings		130				
	,, Transfer to Capital Account		45				
	,, Balance	c/d	25				
			£400				£400
				1955 Jan. 1	By Balance	b/d	25

the rule in *Garner* v. *Murray* is barred), such loss must be borne by the continuing solvent partners in capital ratios; on the other hand, that part of the balance arising through a limited partner's share of *loss* must be borne in profit and loss ratios. By excessive drawings is meant withdrawals in excess of the limited partner's share of profits.

It may be mentioned that in the absence of judicial ruling other views are held in the profession. It is argued for instance that *Garner* v. *Murray* can never apply in a Limited Partnership. Others equally ardently maintain that whether the debit against the limited partner is—to employ the language used in this book—a mere debit balance or an actual debt, the *Garner* v. *Murray* rule is applicable where the limited partner will not or cannot pay the amount in question to the firm, but it seems clear that unless the debit represents a *debt* due by the Limited Partner *and* the deficiency arises through his insolvency the rule in *Garner* v. *Murray* is not applicable; and in any case the general partner(s) admit him on the footing that he is not liable in respect of any sum that merely represents the excess of losses over profits. The Limited Partner before participating in profits earned in the future would be required to bring into account such excess, but this does not constitute a DEBT.

Illustration. A, B, L, M are in partnership, sharing profits and losses in the ratio of 2 : 2 : 1 : 1. Their capitals on 1st January were £1,060, £700, £100, and £240 respectively. A and B are general partners, L and M being limited partners. The drawings for the year were A, £200; B, £150; L, £50; and M, £80. It was decided on 31st December that the partnership should be dissolved, the loss on realization being £900. Show the accounts of the partners, assuming that the limited partners cannot subscribe towards their deficiency. (See page 747.)

SECTION (J) MISCELLANEOUS

Reconstruction.

Where a firm is in financial difficulties, the creditors may decide to give assistance so that the necessity for bankruptcy proceedings may be avoided. Such assistance may take the form of granting to the firm a moratorium, that is, an agreement to forbear for a defined period of time from suing or taking such other remedies for the payment of debts as the law permits. This forbearance is usually accompanied by an agreement for a cancellation of a portion of the firm's liability to the creditors.

In addition, a person, whether a creditor or not, may advance money to the firm for purposes of paying creditors and for working capital. In the latter circumstances the lender may stipulate for an agreed rate of interest, varying with profits or at a definite rate. In consideration of their forbearance, the creditors may stipulate for a share in the profits to cover the discount granted to the firm and reasonable interest.

Dr. **CAPITALS** *Cr.*

Date	Particulars		A £ s. d.	B £ s. d.	L £ s. d.	M £ s. d.
19.. Dec. 31	To Drawings		200 0 0	150 0 0	50 0 0	80 0 0
	,, Loss on Realization		300 0 0	300 0 0	150 0 0	150 0 0
	,, Balances	c/d	560 0 0	250 0 0		10 0 0
			£1,060 0 0	£700 0 0	£200 0 0	£240 0 0
	To Balance	b/d			100 0 0	
	,, Loss not brought in by L. £100 £50 per *Garner v. Murray*[1]	(a)	26 10 0	17 10 0		6 0 0
	£50 in Profit and Loss Ratios	(b)	20 0 0	20 0 0		10 0 0
	,, Balances	c/d	513 10 0	212 10 0		
			£560 0 0	£250 0 0	£100 0 0	£16 0 0
	To Balance	b/d				6 0 0
	,, Loss not brought in by M per *Garner v. Murray*[2]	(c)	3 12 3	2 7 9		
	,, *Balances*	c/d	509 17 9	210 2 3		
			£513 10 0	£212 10 0		£6 0 0

Date	Particulars		A £ s. d.	B £ s. d.	L £ s. d.	M £ s. d.
19.. Jan. 1	By Balances	b/d	1,060 0 0	700 0 0	100 0 0	240 0 0
Dec. 31	,, Balance	c/d			100 0 0	
			£1,060 0 0	£700 0 0	£200 0 0	£240 0 0
	By Balances	b/d	560 0 0	250 0 0		10 0 0
	,, A. B. and M. *per contra*				100 0 0	
	,, Balance	c/d				6 0 0
			£560 0 0	£250 0 0	£100 0 0	£16 0 0
	By Balances	b/d	513 10 0	212 10 0		
	,, A. and B. *per contra*					6 0 0
			£513 10 0	£212 10 0		£6 0 0
19.. Jan. 1	*By Balances*	*b/d*	*509 17 9*	*210 2 3*		

(*a*) This amount being a debt due by L for drawings must be dealt with as above.
(*b*) This amount *not* being a debt, must be dealt with as above.
(*c*) This amount being a debt due by M for drawings must be dealt with as above.

[It is assumed that the withdrawals of L and M are made, not from profits, but out of Capital, otherwise their balances are mere "debit balances" and not debts.]

[1] In ratio of 106 : 70 : 24. [2] In ratio of 106 : 70.

Where a loanholder agrees to become a partner, the usual entries consequent upon the admission of a new partner will be made, except that the balance of loan will be credited to the Capital Account of the loanholder; but in any case it is usual to open a Reconstruction Account to give effect to the terms of the arrangements entered into with the creditors where they agree to a reduction of their claims.

The Reconstruction Account will be debited with losses on revaluation of assets and the expenses of reconstruction, assets and cash being respectively credited. In accordance with the principles previously stated, a revaluation of debtors will take the form of the creation of, or increase in, a Bad Debts Provision, Reconstruction Account being debited and the Bad Debts Provision credited.

Increases in the value of assets and the profit arising from the reduction in the amount of liabilities to the creditors will be debited respectively to the assets and creditors and the Reconstruction Account credited.

The balance of Reconstruction Account will be transferred to the Capital Accounts of the old partners in exactly the same manner as the balance of an ordinary Profit and Loss Account.

Any subsequent profit or loss as compared with the revised book values will accrue to the new firm, so that if a lender has become a partner he will share such profit and bear such loss in the agreed ratio in the usual way. Where the creditors stipulate for a certain proportion of profit in consideration of the assistance rendered to the firm, their accounts will be credited (usually in the form of a total account) and Profit and Loss Appropriation Account debited with the amount to which they are entitled. Upon payment the creditors (or the total account) will be debited and cash credited.

Illustration. The following is the Balance Sheet of Ryland at 31st December, 19..—

BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£		£
Creditors	5,000	Sundry Assets	1,500
Bank	1,400	Debtors	3,500
Fletcher—Loan	1,000	Stock	2,100
		Ryland—Capital	300
	£7,400		£7,400

On 1st January following, a meeting of creditors was summoned owing to the serious financial position of Ryland, at which the creditors, other than the bank, agreed to accept 15s. in the £ in full settlement. Fletcher agrees to make a further advance of £4,500, and to be credited with £5,500 as a partner. Stock is to be revalued at £1,840, and the debtors at £2,300.

In due course the debtors realized £2,480.

Show accounts, assuming that the profit-sharing ratios are to be Ryland 3 : Fletcher 2.

Dr. RECONSTRUCTION (OR CAPITAL ADJUSTMENT) ACCOUNT Cr.

		£			£
19 . Jan. 1	To Bad Debts Provision	1,200	19.. Jan. 1	By Creditors—Allowance 5s. in £ on £5,000 . .	1,250
	,, Stock Provision .	260		,, Loss transferred to Ryland Capital Account . .	210
		£1,460			£1,460

Dr. CAPITALS Cr.

			Ryland	Fletcher				Ryland	Fletcher
			£	£	19..			£	£
19 Jan. 1	To Balance .	b/d	300		Jan. 1	By Cash . .			4,500
	,, Loss on Reconstruction		210			,, Transfer from Loan Account .			1,000
?	,, Balance .	c/d		5,572	?	,, Bad Debts Provision written back		108 [1]	72
						,, Balance .	c/d	402	
			£510	£5,572				£510	£5,572
?	To Balance .	b/d	402		?	By Balance .	b/d		5,572

Dr. CASH Cr.

			£				£
19 Jan. 1	To Fletcher—Capital Account . .		4,500	19.. Jan. ?	By Bank . . .		1,400
?	,, Debtors . . .		2,480	?	,, Creditors . . .		3,750
				?	,, Balance . . .	c/d	1,830
			£6,980				£6,980
?	To Balance . . .	b/d	1,830				

BALANCE SHEET AS AT ? [2]

	£			£
Fletcher—Capital . .	5,572	Sundry Assets .		1,50
		Stock . .	£2,100	
		Less Provision .	260	
				1,840
		Cash . .		1,830
		Ryland—Capital . .		402
	£5,572			£5,572

[1] The profit on realization of Debtors is a partnership profit, and is arrived at as follows—

Debtors' valuation is £3,500 less Provision £1,200. As the debts realize £2,480 there will be a transfer from Debtors Accounts to the Bad Debts Provision of the loss on book values, viz. £1,020 (£3,500 less £2,480), leaving a credit balance to Bad Debts Provision of £180, which is written back to Capitals in the ratio of 3 : 2.

[2] After realization of debtors and payment of creditors.

Partnership Branch Accounts. Where a partnership is carried on at several distinct places it is often arranged to have one partner at each place or group of places, and for such partner in charge to have a profit ratio higher than the others.

The accounting arrangements will vary according to circumstances; for instance, the whole series of separate establishments may be regarded and dealt with as departments with all the assets, liabilities and capitals incorporated in the books of the chief place of business, or the establishments may be regarded as branches and treated accordingly. As will have been seen in Chapter XIX the particular form of branch accounting will vary considerably according to circumstances. Where the establishments are regarded as separate accounting units, the procedure will follow substantially the general pattern of "self-contained" Branches and the incorporation of the separate establishment profits or losses will call for attention.

The entries for the profit of *each* establishment are—

(1) Profit of Local establishment:

Debit Profit and Loss (Appropriation) Account of the establishment.

Credit Resident Partner with his share.

Current Account of each of the other establishments according to the ratio attributable to the resident partner there

(2) Profit of other establishments:

Debit Current Account of each respective establishment.

Credit Local partner's Capital Account for the share attributable to him from the other establishments.

(The treatment of losses will be the reverse.)

Illustration. A, B and C are partners, managing establishments at Andover, Bournemouth, and Canterbury respectively, each place being self-contained. Each partner takes one-half of the profit of his local establishment, the remainder going equally to the non-resident partners. Assuming that the profits are Andover £3,000, Bournemouth £2,000, and Canterbury £800, show in abridged form the entries required for dealing therewith.

A's Books

PROFIT AND LOSS ACCOUNT

Dr.		£			*Cr.* £
To A—½	. . .	1,500	By Balance	. .	3,000
" B—¼	. . .	750			
" C—¼	. . .	750			
		£3,000			£3,000

Dr. **A** *Cr.*

		£			£
			By Profit—½ (*A*) . .		1,500
			„ Profit—¼ (*B*) . .		500
			„ Profit—¼ (*C*) . .		200
					2,200

Dr. **Bournemouth Current Account** *Cr.*

		£			£
To *A*—¼ . . .		500	By Profit—¼ . .		750
„ Balance . . .	c/d	250			
		£750			£750
			By Balance. . .	b/d	250

Dr. **Canterbury Current Account** *Cr.*

		£			£
To *C*—¼ . . .		200	By Profit—¼ . .		750
„ Balance . . .	c/d	550			
		£750			£750
			By Balance. . .	b/d	550

B's Books

Dr. **Profit and Loss Account** *Cr.*

		£			£
To B—½ . . .		1,000	By Balance. . .		2,000
„ A—¼ . . .		500			
„ C—¼ . . .		500			
		£2,000			£2,000

Dr. **B** *Cr.*

		£			£
			By Profit—½ . .		1,000
			„ Profit—¼ (*A*) . .		750
			„ Profit—¼ (*C*) . .		200
					1,950

Dr. **Andover Current Account** *Cr.*

		£			£
To *A*—¼ . . .		750	By Profit—¼ . .		500
			„ Balance. . .	c/d	250
		£750			750
To Balance . . .	b/d	250			

Dr. CANTERBURY CURRENT ACCOUNT **Cr.**

		£			£
To C—¼ . . .		200	By Profit—¼ . .		500
,, Balance . . .	c/d	300			
		£500			£500
			By Balance . .	b/d	300

C's Books

Dr. PROFIT AND LOSS ACCOUNT **Cr.**

		£			£
To C—½ . . .		400	By Balance . .		800
,, A—¼ . . .		200			
,, B—¼ . . .		200			
		£800			£800

Dr. C **Cr.**

					£
			By Profit—½ . .		400
			,, Profit—¼ . .		750
			,, Profit—¼ . .		500
					1,650

Dr. ANDOVER CURRENT ACCOUNT **Cr.**

		£			£
To A—¼ . . .		750	By Profit—¼ . .		200
			,, Balance . .	c/d	550
		£750			£750
To Balance . . .	b/d	550			

Dr. BOURNEMOUTH CURRENT ACCOUNT **Cr.**

		£			£
To C—¼ . . .		500	By Profit—¼ . .		200
			,, Balance . .	c/d	300
		£500			£500
To Balance . . .	b/d	300			

The current accounts in each set of books agree, e.g. the credit (in Andover books) in favour of Canterbury is £550, which agrees with the debit (in Canterbury books) against Andover.

These balances will appear in the separate Balance Sheets of the three establishments and will disappear in the combined Balance Sheet of the firm (similar to Head Office Current and Branch Current Accounts in Branch Accounts where the Branches are self-contained accounting units).

[The figures in ordinary type illustrate rule (1); those in italics rule (2) (see page 750).]

Foreign Exchange

Illustration. J. Bull and U. Samson are in partnership as cotton merchants and brokers, Bull managing the Manchester Office and Samson the New York Office. The profit sharing ratios are—

Manchester	New York
J. Bull—three quarters.	J. Bull—one half.
U. Samson—one quarter.	U. Samson—one half.

The profits for the year to 31st December, 19.., are (1) Manchester, £2,000; and (2) New York, $4,480, a rate of $2·80 to £ to be taken. Show accounts.

The profits will be split thus—

	J. Bull		*U. Samson*		
	$	£	$	£	
Manchester	4,200	1,500 (*a*)	1,400	500 (*b*)	$a + b =$ £2,000
New York	2,240 (*c*)	800	2,240 (*d*)	800	$c + d =$ $4,480
(see p. 754)		£2,300	$3,640		

Entries in the New York books—

(1) Debit Profit and Loss Appropriation Account with J. Bull's share of the American profits.
Credit J. Bull's Current Account with his share of the American profits.

(2) Debit J. Bull's Current Account with the dollar equivalent of U. Samson's share of English profits.
Credit Profit and Loss Appropriation Account with the dollar equivalent of U. Samson's share of English profits.

Entries in the Manchester books—

(1) Debit Profit and Loss Appropriation Account with U. Samson's share of the English profits.
Credit U. Samson's Current Account with his share of the English profits.

(2) Debit U. Samson's Current Account with the sterling equivalent of J. Bull's share of the American profits.
Credit Profit and Loss Appropriation Account with the sterling equivalent of J. Bull's share of the American profits.

Converse entries would be made for losses.

NEW YORK BOOKS

Dr.	J. BULL CURRENT ACCOUNT		*Cr.*
To Profit and Loss Appropriation Account: ½ Share of £2,000 at $2.80 to £	$ 1,400	By Profit and Loss Appropriation Account: ½ Share of $4,480 .	$ 2,240

Dr.	PROFIT AND LOSS APPROPRIATION ACCOUNT		*Cr.*
	$		$
To J. Bull Current Account:		By Profit . . .	4,480
½ share . . .	2,240	,, Manchester Profit .	1,400
,, Balance—U. Samson .	3,640		
	$5,880		$5,880

MANCHESTER BOOKS

Dr.	U. SAMSON CURRENT ACCOUNT		*Cr.*
To Profit and Loss Appropriation Account: ½ share of $4,480 at $2·80 to £	£ 800	By Profit and Loss Appropriation Account: ½ share of £2,000. .	£ 500

Dr.	PROFIT AND LOSS APPROPRIATION ACCOUNT		*Cr.*
	£		£
To U. Samson Current Account:		By Profit. . . .	2,000
½ share	500	,, New York Profit . .	800
,, Balance—J. Bull . .	2,300		
	£2,800		£2,800

Dissolution. On dissolution it will be necessary to adjust any profit or loss on exchange, such being treated as a profit or loss on realization. It is usual to treat the latter equally between the partners as it cannot strictly be said to arise in the course of trading operations of either of the businesses, but from a settlement of capital balances.

Illustration. The following are the Balance Sheets of the partners in the foregoing illustration.

MANCHESTER BALANCE SHEET

	£		£
J. Bull—Capital . . .	5,000	Sundry Assets . . .	4,000
		U. Samson—Current Account	1,000
	£5,000		£5,000

NEW YORK BALANCE SHEET

Assets[1]	$	*Liabilities*[1]	$
Sundry Assets . . .	52,800	U. Samson—Capital .	50,000
		J. Bull—Current Account .	2,800
	$52,800		$52,800

On that date the partnership is dissolved and the assets realize: Manchester, £5,000; New York, $50,000. All the entries relative to the dissolution are to be put through the books at the rate of $2·80 to £. When the final remittance is made the rate is $2·60 to £. Show accounts.

MANCHESTER BOOKS

Dr. REALIZATION ACCOUNT *Cr.*

		£			£
To Sundry Assets . .		4,000	By Cash . . .		5,000
,, Expenses . .		?			
,, Profit on Realization— J. Bull ¾ . £750; U. Samson ¼ . 250		1,000			
		£5,000			£5,000

Dr. J. BULL CAPITAL *Cr.*

		£			£
To Loss on Realization— New York $1,400 at $2·80 to £ . .		500	By Balance . .	b/d	5,000
,, Balance . .	c/d	5,250	,, Profit on Realization—Manchester		750
		£5,750			£5,750
			By Balance . .	b/d	5,250

Dr. U. SAMSON CURRENT ACCOUNT *Cr.*

		£			£
To Balance . . .	b/d	1,000	By Profit on Realization—Manchester		250
			,, Loss on Realization—New York $1,400 at $2·80 to £ .		500
			,, Balance . .	c/d	250
		£1,000			£1,000
To Balance . . .	b/d	250			

Dr. CASH *Cr.*

		£			
To Realization Account.		5,000			

[1] In accordance with American practice.

It will be seen that the total of the Cash and U. Samson Current Account equals the balance due to J. Bull as shown in his Capital Account.

New York Books

Dr. Realization Account *Cr.*

		$			$
To Sundry Assets .		52,800	By Cash . . .		50,000
,, Expenses . .		?	,, Loss on Realization—		
			U. Samson ½ $1,400		
			J. Bull ½ $1,400		2,800
		$52,800			$52,800

Dr. U. Samson—Capital *Cr.*

		$			$
To Loss on Realization—New York		1,400	By Balance . .	b/d	50,000
,, Balance . .	c/d	49,300	,, Profit on Realization—Manchester £250 at $2·80 to £		700
		$50,700			$50,700
			By Balance .	b/d	49,300

Dr. J. Bull—Current Account *Cr.*

		$			$
To Profit on Realization—Manchester £250 at $2·80 to £		700	By Balance . .	b/d	2,800
,, Loss on Realization—New York		1,400			
,, Balance . .	c/d	700			
		$2,800			$2,800
			By Balance . .	b/d	700

Dr. Cash *Cr.*

		$			
To Realization Account		50,000			

As the rate of exchange at the date of the final remittance is $2·60 to the £ the dollar price of £250 is $650, hence a profit of $50; as this profit is shared equally, U. Samson will retain $25 of the $700, remitting $675 due to J. Bull, i.e. $650 plus his share of profit on exchange of $25. The remittance of $675 at $2·60 to £ (ignoring expenses) will produce £259 12s. 4d.

The final entries will be—

MANCHESTER BOOKS

Dr. J. BULL—CAPITAL Cr.

		£	s.	d.			£	s.	d.
To Balance . .	c/d	5,259	12	4	By *Balance* . .	b/d	*5,250*	*0*	*0*
					„ Profit on remittance — $25 at $2·60 to £		9	12	4
		£5,259	12	4			£5,259	12	4
					By Balance .	b/d	5,259	12	4

Dr. U. SAMSON—CURRENT ACCOUNT Cr.

		£	s.	d.			£	s.	d.
To *Balance* . .	b/d	*250*	*0*	*0*	By Draft . .		259	12	4
„ Profit on remittance — $25 at $2·60 to £		9	12	4					
		£259	12	4			£259	12	4

Dr. CASH Cr.

		£	s.	d.			£	s.	d.
To *Balance* . .	b/d	*5,000*	*0*	*0*	By Balance .	c/d	5,259	12	4
„ Remittance—U. Samson Current Account — $675 at $2·60 to £ .		259	12	4					
		£5,259	12	4			£5,259	12	4
To Balance . .	b/d	5,259	12	4					

NEW YORK BOOKS

Dr. U. SAMSON CAPITAL Cr.

		$			$
To Balance . .	c/d	49,325	By *Balance* . .	b/d	*49,300*
			„ Profit on remittance—£9 12s.4d. at $2·60 to £ .		25
		$49,325			$49,325
			By Balance . .	b/d	49,325

Dr. J. BULL—CURRENT ACCOUNT *Cr.*

		$			$
To Draft—£259 12s. 4d. at $2·60 to £		675	By *Balance*	b/d	700
,, Profit on remittance £9 12s. 4d. at $2·60 to £		25			
		$700			$700

Dr. CASH *Cr.*

		$			$
To *Balance*	b/d	*50,000*	By Remittance—J. Bull Current Account—£259 12s. 4d. at $2·60 to £		675
			,, Balance	c/d	49,325
		$50,000			$50,000
To Balance	b/d	49 325			

The cash in hand in each country is now sufficient to pay out the Capital Accounts of J. Bull and U. Samson.

Examination Problem. A, B, and C were in partnership, sharing profits in the proportions of 5, 4, and 3, and accounts were prepared annually as on 31st December. Interest at 5 per cent per annum was allowed on capital accounts, but no interest was charged on drawings.

The partnership agreement provided that in the event of the death of a partner during any year no special accounts should be prepared until the end of the year, when the amount due to the deceased partner's estate was to be calculated as follows—

(*a*) *Profits* (before charging partnership interest) were to be apportioned *on a time basis* in months up to the end of the calendar month in which the partner died, the profits accruing up to such date to be divided as though the partner had lived to the end of the month.

(*b*) Goodwill was to be calculated on the basis of *two years' purchase* of the average *profits* (*after deducting partners' interest*) for the three years immediately preceding the end of the month in which the partner died, a year's profits to be apportioned (in months) if necessary.

(*c*) The deceased partner's capital and current accounts, share of profits under (*a*) above and of goodwill under (*b*) above to be added together, and the total so found to carry interest at the rate of 5 per cent per annum from the first day of the month following his death until paid.

The surviving partners, failing any other agreement, were to continue sharing subsequent profits in the same ratio as had previously applied as between themselves.

A died on 20th June, 1953.

On 1st October, 1953, D was admitted as a partner, and the profit sharing ratio from that date as between B, C, and D was 5, 4, and 2; the profits of the year in which D became a partner were agreed to be apportioned on a time basis.

Profits *before* charging any interest, were as follows—

Year to 31st December, 1950	. .	£5,142
,, ,, ,, 1951	. .	£4,192
,, ,, ,, 1952	. .	£3,627
,, ,, ,, 1953	. .	£3,976

At no time previous to 1953 did the Balance Sheet include any Goodwill Account. A's Capital Account stood at £10,000 throughout the whole period up to his death, and B's at £6,000. C had £4,000 up to 1st August, 1953, when he brought in a further £1,200. On 1st October, 1953, D brought in £3,200, of which £2,000 was credited to his Capital Account, while the balance, agreed as representing his share of goodwill, was credited to the Capital Accounts of B and C in their old profit sharing ratios. These several sums were paid over to A's executors immediately they were received, and, in addition, £1,000 was paid over on 1st December, 1953, out of cash in hand.

As on 31st December, 1952, A's Current Account was in credit to the extent of £805, and during 1953 he had drawn £100 at the commencement of each month.

You are required to calculate the balance due to A's estate and the division of profits between the other partners as on 31st December, 1953. (Calculations to the nearest £ and income tax ignored.)

(*Institute of Chartered Accountants Final.*)

Relevant accounts appear on page 760.

The division of the Interest on the amount due to A's executors is as follows—

	£	£
Interest @ 5% per annum for 1 month on £13,680 .	57	
,, ,, ,, ,, 2 months on £12,480 .	104	
		161
,, ,, ,, ,, 2 months on £9,280 .	77	
,, ,, ,, ,, 1 month on £8,280 .	35	
		112
		£273

Notes (i) Computation of Goodwill—

	£
One-half of profits to 31st December, 1950 . . .	2,571
Profits to 31st December, 1951	4,192
,, ,, ,, ,, 1952	3,627
One-half of profits to 31st December, 1953 . . .	1,988
	12,378
Less Interest on Capital (£1,000 annually) . .	3,000
	3)9,378
Average	£3,126
2 years' purchase	£6,252
A's *share* thereof $\frac{5}{12}$ × £6,252	£2,605

Profit and Loss Appropriation Account for the Year Ended 31st December, 1953

Dr

		6 months to 30th June		3 months to 30th Sept		3 months to 31st Dec.
		£		£		£
To Interest on Capital—						
A		250				
B		150		57		66
C		100		46		56
D						25
,, Interest on Loan (A)				161		112
,, Balance—						
A	$\frac{5}{12}$	620				
B	$\frac{4}{12}$	496	$\frac{4}{7}$	417	$\frac{5}{11}$	334
C	$\frac{3}{12}$	372	$\frac{3}{7}$	313	$\frac{4}{11}$	267
D					$\frac{2}{11}$	134
		£1,988		£994		£994

Cr.

		6 months to 30th June	3 months to 30th Sept.	3 months to 31st Dec.
		£	£	£
By Balance	b/d	1,988	994	994
		£1,988	£994	£994

Executors of A (Loan)

Dr

1953			Months	Interest	Principal
				£	£
Aug 1	To Cash		5	25	1,200
Oct. 1	,, ,,		3	40	3,200
Dec. 1	,, ,,		1	4	1,000
31	,, Balance of Interest to Contra			273	
	,, Balance		c/d		8,553
				£342	£13,953

Cr.

1953			Months	Interest	Principal
				£	£
June 20	By Transfer from Capital Account				10,000
	,, Transfer from Current Account				205
	,, Interest on Capital (to 30th June, 1953)				250
	,, Share of Profits (to 30th June, 1953)				620
	,, B and C—Transfer *re* Share of Goodwill				2,605
					13,680
Dec. 31	,, Interest on £13,680		6	342	
	,, Balance of Interest from *Contra*				273
				£342	£13,953
1954 Jan 1	By Balance		b/d		8,553

(ii) Statement of Capital Accounts of B and C—

				B		C
1953				£		£
Jan. 1.	Balances			6,000		4,000
June 30.	*Less* Share of Goodwill credited to A		$\frac{4}{7}$	1,489	$\frac{3}{7}$	1,116
	Balances at 30*th June*			4,511		2,884
Aug. 1.	Cash brought in			—		1,200
	Balances at 1*st August*			4,511		4,084
Oct. 1.	Share of Goodwill purchased by D		$\frac{4}{7}$	686	$\frac{3}{7}$	514
				5,197		4,598
	Adjustment between B and C *re* purchase of share of goodwill consequent upon change of profit-sharing ratios (per Statement iii)		+	86		86
	Balances at 1*st October*			£5,283		£4,512

(iii) Statement of Goodwill Adjustment—

Goodwill (£6,600)

		B		C
		£		£
Old ratio of $\frac{9}{11}$ of Goodwill [i.e. £5,400]	$\frac{4}{7}$	3,086	$\frac{3}{7}$	2,314
New ratio of $\frac{9}{11}$ of Goodwill	$\frac{5}{9}$	3,000	$\frac{4}{9}$	2,400
	Cr.	£86	*Dr.*	£86

The amount of £6,600 is $\frac{11}{2}$ × £1,200—D paying £1,200 for $\frac{2}{11}$ share.

As B previously had $\frac{4}{7}$ as against $\frac{3}{7}$ to C and is now to have $\frac{5}{9}$ he is a seller of $\frac{1}{63}$ $\left[\frac{36-35}{63}\right]$. Such proportion of $\frac{9}{11}$ of £6,600 equals £86.

Treating the Goodwill on the "Share sold" method the computation is—

(Goodwill £6,600)

	B	C	D
Old ratio	$\frac{4}{7}$	$\frac{3}{7}$	—
New ratio	$\frac{5}{11}$	$\frac{4}{11}$	$\frac{2}{11}$
	Cr. $\frac{9}{77}$ = £772	*Cr.* $\frac{5}{77}$ = £428	*Dr.* $\frac{2}{11}$ = £1,200

Thus D having paid the £1,200, the adjustment as between B and C is—

	B	C
	£	£
Share of Goodwill due	772	428
Credited in accounts	686	514
Adjustment	*Cr.* £86	*Dr.* £86

(iv) Statement of Interest on Capital—

INTEREST ON CAPITAL

Dates	M'ths	A Interest	A Capital	B Interest	B Capital[1]	C Interest	C Capital[1]	D Interest	D Capital
1953		£	£	£ £	£	£ £	£	£	£
Jan. 1 to June 30	6	250	10,000	150	6,000	100	4,000		
July 1 to July 31	1			19	4,511	12	2,884		
Aug. 1 to Sept. 30	2			38	4,511	34	4,084		
				— 57		— 46			
Oct. 1 to Dec. 31	3			66	5,283	56	4,512	25	2,000
		£250		£273		£202		£25	

(v) *The balances of the Current Accounts of B and C assumed to be kept separately from the Capital Accounts.*

[1] Per Capital Statement (see note ii).

CHAPTER XXIII

LIMITED COMPANY ACCOUNTS

SECTION (A)—INTRODUCTION

GENERAL PRINCIPLES

THE subject-matter comprised under this head is probably the most important of all for the examination student, special papers being set in almost all the examinations of the professional bodies on the subject of Limited Company Accounts.

Before proceeding to the accounts proper, it is essential to outline briefly certain important general principles.

These may be summarized as follows—

1. A limited company is a body corporate, that is, an aggregation of persons and individuals, arising by Statute or Royal Charter, having the status of a separate "being" or person, the liability of whose members is limited according to circumstances.

The type of limited company which most concerns the accountancy profession is that formed under the Companies Acts, 1929 and 1947, now consolidated in the Companies Act, 1948.[1] The company may have a share capital with the liability of the shareholders limited to the amount remaining unpaid on the shares for which they have subscribed; or it may have no share capital, the liability being limited to the amount members agree in the form of a guarantee. It must always be considered as a separate "being," irrespective of the individuals who have subscribed the necessary capital. As such, it is able to sue or be sued, hold land, carry on business, and, subject to the obvious fact that it must exercise these activities through the medium of animate persons, is generally capable of exercising the functions of an individual, with certain penalties for transgression. Penalties of a monetary nature can be enforced against the company; in addition, companies, like individuals, are liable to have their property seized, e.g. by distress; but clearly, many penalties of a more "physical" nature must be visited upon the individuals in control. Although it is beyond the scope of this work to deal with legal topics, it may be stated that a limited liability company is incapable of committing a felony; the law of slander has a limited application thereto; whilst the criminal code is but partly applicable to companies. The company begins its legal life by being incorporated, which is evidenced by a certificate of incorporation, and closes it when it is dissolved through the legal process known as "liquidation."

2. Share Capital must ALWAYS be kept quite distinct from the

[1] And older companies incorporated under previous Companies Acts.

balance of profit and loss. In partnership, the proprietors transfer their proportions of profit or loss either to their respective Capital Accounts or to their Current (or Drawings) Accounts. In limited companies, however, no member is entitled to receive a share of the profits until there has been a "declaration of a dividend" by the directors, approved by the members. In addition, it will be remembered that partners (subject to contrary agreement) share profits or losses equally, but members of a company share on a CAPITAL basis whenever a distribution of profits is made.

3. There are frequently distinct grades or classes of share capital, distinguished generally by one class having a privilege not possessed by another, e.g. a prior right to the payment of dividends or the first right to capital repayment as against another class of share capital if the company goes into liquidation.

4. A person who LENDS money to a limited liability company usually receives an acknowledgment under seal (which, when witnessed by authorized persons, is the evidence of an act done by a limited liability company). Such lender is termed a Debenture-holder. A loan may or may not be accompanied by a charge on some of the assets of the company; but the existence of a charge is not a necessary LEGAL element, however desirable from a business point of view. It is therefore of the greatest importance to note the contrast between the position of a member and a debenture-holder. Where one person holds *both* shares *and* debentures, then his rights as a member are distinct from those as a debenture-holder.

The main distinctions between debentures (and debenture-holders) and shares (and members) are summarized thus—

(*a*) A member is a part owner, i.e. a co-proprietor, whilst a debenture-holder is a CREDITOR, so that—

(*b*) In a liquidation the latter claims payment as a creditor, whilst the member together with his co-members may receive repayment wholly, or in part, only after the costs of liquidation and the liability to creditors, including debenture-holders, have been met.

(*c*) The right to INTEREST on a debenture is not dependent upon profits. It is a right, varying according to the terms of the debenture, which may be enforceable against the company—even if during the period in which the interest is accruing the company has sustained a loss; it therefore constitutes a definite CHARGE against profits; in other words, profits cannot be said to have been earned unless and until full provision has been made in the accounts for debenture interest. Furthermore, the right to payment is not dependent upon any declaration as in the case of a dividend. On the other hand, the member obtains a dividend only when—

(i) there have been profits earned; followed by

(ii) declaration of dividend; which will rarely be such as to divide the whole of the profits earned.

Therefore, such a payment of dividend is a DISPOSITION,

DISTRIBUTION, or APPROPRIATION of profits and in no way a charge against them. In short, it may be stated: "no profits and declaration, no dividend."

(*d*) A debenture may be issued at par, premium, or at a discount, whilst a share (i.e. a portion of the capital) may be issued at par or at a premium; but ONLY SUBJECT TO IMPORTANT RESTRICTIONS laid down in the Companies Act, 1948, may it be issued at a discount. Further, capital (with one exception) is not ordinarily repayable to the members other than in liquidation. Debentures, however, may be either redeemable or permanent.

On the other hand, a common feature is that upon payment income tax at the standard rate must be deducted from the gross sum payable by way of INTEREST on debentures or DIVIDENDS on shares.

5. A limited liability company can only exercise such functions as come within the scope of its powers as laid down by the objects clause of the Memorandum of Association—one of the documents that must be filed with the Registrar of Companies, before incorporation; whilst the directors are endowed with certain powers as laid down in the Articles of Association (which must be filed along with the Memorandum). The Memorandum is the vital document because no confirmation of an act improperly done in contravention of the Memorandum can give validity to the act; being in sharp contrast to the Articles which, as it were, form the by-laws of the company, for an act done beyond the powers defined in the Articles may be confirmed or ratified by the members of the company.

6. The Companies Act, 1948, requires the registration of many acts and transactions. In addition, it compels the company to furnish details of members and their holdings and many other particulars in a document called the Annual Return; whilst certain books, called Statutory Books, must be kept, and subject to certain limitations, some of them, e.g. register of members, are open for inspection by the public.

7. The Companies Act, 1948, contains provisions as to keeping accounts, furnishing accounts to members and debenture-holders, the holding of meetings, the voting rights of the members, and the contents of the Profit and Loss Account and Balance Sheet.

8. In certain exceptional cases, subject to the sanction of the Court, the share capital of the company may be reduced, modified, or re-arranged.

Alphabetical Summary. In order to assist the student to observe the essential differences between non-limited company and limited company matters the following alphabetical summary is given—

A = Articles; authority of directors; agency of directors and their strict accountability to members; auditor necessary.

B = Borrowing powers; no Bill of Sale can be given as security nor can there be bankruptcy of a limited company; books of account.

C = Capital; control; importance of case law *re* limited companies.
D = Direction by directors; debentures only in a limited company; no drawings in limited companies; dividends; disclosure of certain details, e.g. directors' names, etc.; distringas notice; death of member does not dissolve the company; disclosure of required details.
E = Enlargement of scope of company activities limited by statute; legal entity of a limited company.
F = Forfeiture of shares in limited companies; foreign holders of shares do not affect domicile of company; regulations regarding companies registered in foreign countries; fiduciary position of directors; filing documents.
G = Governing Act—Companies Act, 1948; [Partnership Act, 1890; Limited Partnership Act, 1907; Business Names Act, 1916, the latter applying equally to sole traders, partnerships, and Limited Companies].
H = Home or domicile.
I = Income tax position; invalidity of certain acts beyond the scope of the company: Interest on Construction Capital: Investigation regulations.
J = (Usually) joint and several liability of holders of shares to pay the amount necessary on the shares.
K = Keeping open certain Statutory Books in the case of a limited company.
L = Liability of members limited; lien of company on shares; lunacy or insanity of member of company does not give any right to dissolve; liquidation.
M = Meetings; Memorandum; management; minutes.
N = Notices of meetings; name of company; numbers of members and directors, minimum and maximum.
O = Office (registered); objects clause; officers.
P = Prospectus; profits; preliminary expenses; priorities of classes of members to dividends and capital; polls; proxies; public and private companies.
Q = Qualification shares of directors; quorum.
R = Reserves; Reduction of Capital; Reports of Directors and Auditors; Requisitionist meetings; Registered office.
S = Stamp duties; seal of company; Stock Exchange quotation; secretary.
T = Transfer of shares; termination of company; time limits for registering documents, notices, etc., Table A; Tax.
U = Underwriting.
V = Voting powers.
W = Winding-up provisions.

The above alphabetical indicator, it must be understood, does no more than point out to the student the dominant legal topics connected with the affairs of limited companies.

Before proceeding with the treatment of the accounts a brief summary is appended showing the chief differences between a partnership and a limited company; and private and public companies.

Points	Partnership	Limited Company
1. Regulating Act(s)	Partnership Act, 1890. Limited Partnership Act, 1907. Business Names Act, 1916.[1]	Companies Act, 1948. Business Names Act, 1916.[1]
2. Members . .	Limited to 20—except banking partnership, which is 10.	Private company—minimum of 2 and maximum of 50 (exclusive of certain individuals). Public company—minimum of 7 and no maximum (except there can be no more members than shares).
3. Entity . .	Not a legal entity, except in Scotland.	Is a legal entity.
4. Liability . .	Unlimited, except in a limited partnership as regards the limited partner.	Limited. [Directors' Liability may be made unlimited.]
5. Capital . .	As partners agree. Alterations as partners agree. Withdrawals as partners agree.	Maximum issued share capital must not exceed authorized capital upon which a duty of 10s.% is payable. Alterations in rights must conform to certain formalities; capital cannot usually be withdrawn.
6. Profits .	As partners agree, otherwise equally. May be added to capitals.	Distribution of profits depends upon declaration based upon type and numbers of shares held. Cannot be added to capital unless by way of bonus shares.
7. Management .	All entitled to take part (excepting a limited partner); inspect books and take copies.	Management vested in a number of individuals, usually but not necessarily shareholders, called directors. Members cannot inspect account books, but must be sent Balance Sheets and Profit and Loss Accounts.
8. Tax . . .	*All* income receivable by a partner from the firm is included in the partnership assessments for Income Tax and Sur-tax. No tax deduction on distribution, and all profits are "earned" income. Upon a change of partners the business may be assessed as a continuing or a new business. Not liable to Profits Tax.	Remuneration of directors is a proper charge against company profits. Dividends must have tax deducted at standard rate of Income Tax and are "unearned" income.[2] Special provisions in regard to sur-tax. Upon partners converting the business into a limited company, the income tax rules relating to a discontinued business (*re* partners) and to a new business (*re* limited company) must be observed. Wear and Tear allowances unused by partnership will be lost, but losses unused may be set off against the income of the partners who are shareholders in the new company. Liable to Profits Tax.
9. Audit . .	Not compulsory.	Compulsory.
10. Winding-up .	Carried out under bankruptcy rules if bankrupt.	Carried out in alternative ways under the Companies Act.
11. Books . .	No legal necessity to keep books of account but, in practice, books of account are necessary and open to inspection of all partners.	Proper books of account must be kept. Not accessible to members (unless regulations so provide).

[1] The Registrar can refuse to register names he considers undesirable, both in the case of partnerships and sole traders, and also companies (Sect. 116, Companies Act, 1947).

[2] But usually in private companies, directors will take profit in form of directors' fees as far as possible to obtain maximum earned income allowance.

Points	Partnership	Limited Company
12. Powers . .	Can carry on such trade or business agreed upon: and subject to any change agreed upon.	Limited to what is prescribed in the Memorandum of Association. [In practice, very wide powers are prescribed in the memorandum.] Further powers can be acquired within certain stated limits. Powers of *Directors* can by special resolution be curtailed or varied.
13. Control. .	Equal, subject to contrary agreement.	Immediate control by Directors. Ultimate control by the members, but in both cases voting power is *deciding* factor. As shares can be issued carrying no voting power real control might be exercised by Directors without holding more than a very small amount of the capital.
14. Devolution and Transfer . .	Share transferable only if remaining partners agree. Death dissolves firm (unless partnership agreement provides otherwise) and deceased's share *must* be paid as agreed.	Shares (subject to restrictions or conditions in Articles) are transferable, thus on death of member share is more readily renderable. Death of member does not dissolve the company. Shares are not repayable: personal representative must either (*a*) hold, (*b*) sell, or (*c*) transfer to a legatee where empowered to do so.
15. Death Duties .	Payable always on value of partner's share based on "asset values" [including goodwill].	Payable on market value of shares held by deceased member, based on asset values in certain cases under Sect. 55 Finance Act, 1940. See Chap. XXVII, valuation of shares.
16. Statutory Requirements .	No special stamp duties. No publicity or returns. (Except in Limited Partnership.)	Special stamp duties on formation. Publicity of the information required on registration: on creating charges or through annual return to Registrar of Companies.

Private Companies. A private company is defined by the Companies Act, 1948, Sect. 28, as follows—

A company which by its articles

(*a*) restricts the right to transfer its shares;

(*b*) limits the number of its members to fifty, not including persons who are in the employment of the company and persons who, having been formerly in the employment of the company, were while in that employment, and have continued after the determination of that employment to be, members of the company; and

(*c*) prohibits any invitation to the public to subscribe for any shares or debentures of the company.[1]

Joint-holders of shares are counted for this purpose as one person.

[1] Including an offer or invitation made to any section of the public, whether selected as members or debenture-holders of the company concerned, or as clients of the person issuing the prospectus or in any other manner. But the offer or invitation will not be so treated if in all the circumstances it can properly be regarded as not being calculated to result, directly or indirectly, in the shares or debentures becoming available for subscription or purchase by persons other than those receiving the offer or invitation, or otherwise as being a domestic concern of the persons making and receiving it, so that a

Exempt Private Companies. Both public and private companies are required to "publish" their accounts by annexing a copy to the Annual Return (see page 778), but a private company may claim exemption provided that—

(1) The number of debenture-holders (like the shareholders) does not exceed 50.

(2) No body corporate is a director and no arrangement is permitted whereby the company's affairs can be directed by any persons other than directors, shareholders, debenture-holders or trustees for debenture holders.

(3) No body corporate is a holder of shares or debentures except, in certain cases, for *shares* held by an "exempt" private company.

(4) No person other than the holder is interested in the shares or debentures (vide Sect. 129 and 7th Sch.).

In regard to (4) there are provisions to deal with shares or debentures charged; the estates of deceased persons, pending completion of the administration; where a purchaser has bought shares or debentures and not yet registered; and where the holder is under a disability and his property is vested in an administrator.

An "exempt" private company need not forward to the Registrar of Companies a *printed* copy of a resolution or agreement required under the Companies Act, 1948, Sect. 143 (1), provided a copy is forwarded in some other form approved by the Registrar; nor is it prohibited from making loans to its directors (Sect. 190).

Certain privileges and exemptions are granted to private companies. The differences between private and public companies may be tabulated thus—

Points	Private	Public
1. Minimum number of members	Two.	Seven.
2. Maximum number of members	Fifty (*cf.* above).	Unlimited (*cf.* above).
3. Transfer of shares	Restricted.	Unrestricted.
4. Invitations to the public to subscribe	Not allowed.	Allowed.
5. Statutory report and meeting	Not necessary.	Necessary.
6. Minimum number of directors	One.	Two.
7. Restrictions on appointment of directors	Not applicable.	Applicable.
8. Filing of statement in lieu of prospectus	Not required.	Required.
9. Restrictions as to minimum subscription and allotment	Not applicable.	Applicable.
10. Restrictions as to commencement of business	Not applicable.	Applicable.
11. Annual Return—inclusion therein of the last Profit and Loss Account and Balance Sheet and Auditor's Report and other documents.	"Exempt" company need not include Balance Sheet, etc., but officers must sign declaration of compliance with regard to number of members, and conditions allowing exemption.	Must include such Balance Sheet, etc.
12. Share warrants	Cannot issue.	May issue.
13. Proxy holders	May speak at meetings.	May not speak at meetings.

provision in a company's articles prohibiting invitations to the public to subscribe for shares or debentures shall not be taken as prohibiting any invitation to members or debenture-holders which can properly be regarded as conforming to the above conditions (*vide* Companies Act, 1948, Sect. 55).

SUMMARY OF DIFFERENT TYPES OF COMPANIES

Point of Difference	Statutory Company	Joint Stock Company	Chartered Company
Constitution	Special Act of Parliament	Companies Acts	Royal Charter
Powers	Laid down by Act; and alterable thereunder	Laid down by Memorandum of Association; with right to amend within certain stated limits	Laid down by Royal Charter and unalterable (except by new Charter)
Liability	Limited	Usually limited; may be unlimited if laid down by Memorandum of Association	Limited
Numbers	Limited by number of shares	Limited by number of shares in a public company. Limited to 50 (excluding past or present employees) in a private company. Minimum numbers, public 7; private 2	Limited by shares; or may be unlimited according to the terms of the Charter
Control	Directors	Directors	Directors (or Governors)
Accounts	Compulsory (each Act lays down particular requirements)	Compulsory	As laid down by Charter —usually compulsory
Audit	Do.	Do.	Do

LIMITED COMPANY ACCOUNTS

The general principles of accounting apply to the accounts of limited companies, modified in detail to fit the special peculiarities of such companies and in certain instances to comply with legal requirements. In addition, certain books are required to be kept, and certain information furnished to the Registrar of Companies.

It will readily be perceived that some measure of protection must be afforded to the members of the company, who, unlike partners, cannot usually personally direct the business of the company and (in the case of a large company) will not be acquainted with each other. The Companies Act, 1929, modified in the light of the experience gained from the operation of previous Companies Acts, permitted the exercise of reasonable powers by the persons in control of the company free from unwarranted interference from the body of members, whilst at the same time it made numerous provisions for the safeguarding of the interests of the members.

The Companies Act, 1947 (substantially enacting the recommendations of the Cohen Committee's Report, made after a very exhaustive inquiry into the deficiencies, ambiguities and weakness of the Companies Act, 1929) considerably stabilized this relationship between directors and members.

In order to obtain a thorough mastery of company accounting, the essential requirements of the Companies Act, 1948, so far as they have bearing on the accountancy aspect, must be assimilated. Below are enumerated the vital matters, full treatment of which cannot be contemplated here as much of the explanation lies within the scope of a legal treatise.

1. The definition of a joint-stock company.
2. The classification of incorporated bodies.
3. The method of formation of an incorporated body.
4. The distinction between private and public companies.
5. The contents and significance of the Memorandum of Association, particularly in relation to objects.
6. The contents and significance of the Articles of Association.
7. The contents and significance of Table "A."
8. Prospectus; minimum subscription.
9. Statement in lieu of prospectus.
10. Certificate of incorporation and certificate entitling company to commence business.
11. The meaning of the company terms: vendor, promoter, etc.
12. Common and official seal.
13. Officers of the company.
14. Share certificates and share warrants.
15. Types of meetings: procedure, quorum, polls, proxies, and resolutions.
16. Stamp duties.
17. Preliminary expenses.
18. Auditors' report and Directors' report.
19. The law relating to transfers, particularly blank transfers, forged transfers, and certified transfers.
20. Income tax, profits tax (and sur-tax in certain cases).

In addition the following matters relating to the accounting side will be specifically dealt with as under—

(*A*) In Chapter XXIII (*b*).

21. Profit and Loss Account and Balance Sheet; the keeping of accounts; the furnishing of accounts to members; Auditors' and Directors' Reports.
22. Statutory Books; Annual Return.
23. Statistical Books.
24. Registration and filing of resolutions and documents.

(*B*) In the following sub-chapters limited company accounting will be dealt with in detail.

25. Share capital: issue, alteration, reduction, consolidation and subdivision, reorganization, forfeiture and reissue of shares. (Chapters XXIII (*c*), and XXIII (*e*).)
26. Debentures: issue, interest, and redemption. (Chapter XXIII (*d*).)
27. Opening and "acquisition" entries of a company; underwriting commission and final accounts. (Chapter XXIII (*f*).)
28. Profits: divisible, capital, prior to incorporation (and losses). (Chapters XXIII (*g*), and XXIII (*f*).)
29. Dividends, including arrears of cumulative preference dividends; forfeiture; scrip dividends and bonus shares. (Chapter XXIII (*h*).)
30. Reconstructions, amalgamations, and absorptions. (Chapter XXIII (*i*).)

SECTION (B)—BOOKS, RETURNS, ACCOUNTS, ETC.

Books of Account. The Companies Act, 1948, provides that every company must keep proper books of account as to—

(*a*) All sums of money received and expended by the company and the matters in respect of which the receipts and expenditure take place.

(*b*) All sales and purchases of goods by the company.

(*c*) Assets and liabilities of the company. (Sect. 147 (1).)

The books of account must be such as are necessary to give a true and fair view of the state of the company's affairs and to explain its transactions (Sect. 147 (2)).

When books of account are kept outside Great Britain, such accounts and returns with respect thereto as will disclose with reasonable accuracy the financial position, at intervals not exceeding six months, must be—

(*a*) sent to, and
(*b*) kept at a place in Great Britain.

They must be open to inspection at all times by the directors and be such as will enable the company's Balance Sheet and Profit and Loss Account to be prepared (Sect. 147 (3)).

Reasonable steps must be taken to comply with the accounting provisions of the Act, but a director will not be liable if he can show that he had reasonable ground to believe, and did believe, that a competent and reliable person was charged with the duty of complying with such provisions and was in a position to discharge that duty (Sect. 147 (4)).

Books of account other than bound books are permitted provided adequate precautions are taken against falsification (Sect. 436).

Profit and Loss Account, Balance Sheet, and Reports. Not later than eighteen months after the incorporation of the company and subsequently once in every calendar year, the directors must lay before the company in general meeting a Profit and Loss Account (or in the case of a non-trading company, an Income and Expenditure Account) for the period since the company's incorporation (as regards the first account), and subsequently, since the preceding account, made up to a date not earlier than nine months before the general meeting (or twelve months where a company carries on, or has business interests abroad) subject, however, to the power of the Board of Trade to extend the above-mentioned periods.

In addition, a Balance Sheet as at the date to which the Profit and Loss or Income and Expenditure Account is made up, must, each calendar year, be laid before the company in general meeting accompanied by the Directors' Report and the Auditors' Report. The Balance Sheet must give a true and fair view of the company's affairs and the Profit and Loss Account similarly of the profit or loss of the company. Both the Balance Sheet and the Profit and

Loss Account must comply with the requirements of the eighth schedule to the Companies Act, 1948. Any change in the nature of the company's business or its subsidiaries or in the class of business in which the company has an interest, unless such changes are not material or disclosure would be harmful to the company, must be dealt with in the Directors' Report.

Illustration of Directors' Report.

[NAME OF COMPANY].

DIRECTORS' REPORT

TO THE MEMBERS,

The Directors submit herewith their Report and Accounts for the year ended 31st January, 19...

The presentation of the Accounts has been delayed owing to the fact that the accounts from the Northland Branch were not received until the 31st May.

		£
The Trading Profit for the year amounted to		141,000
Less—		
Directors' Fees	£3,000	
Depreciation	7,200	
		10,200
		130,800
Deduct: Taxation on current profits—		
Profits Tax	£16,500	
Income Tax	58,500	
		75,000
Leaving a balance of		55,800
Add—		
Balance brought forward from previous Accounts.		7,600
		63,400
Deduct—		
Preference Dividend (*less* Tax) to 1st February, 19..		3,000
Leaving a net balance of		£60,400

Your Directors recommend that this sum be dealt with as follows—

	£
To General Reserve	10,000
,, Writing off the whole of the expenses of Issue of Capital	10,350
,, Staff Superannuation Fund	2,000
,, Payment of a Dividend of 20% on the ordinary Shares, which, after deducting Income Tax, will require	24,625
Leaving a balance to be carried forward of	13,425
	£60,400

[*Note.* The placing of dividends last in the list of appropriations.]

The Directors are pleased to be able to report that the business of the company during the past year continued to progress in every department, and that the Sales for the first three months of the current year show an increase over the corresponding period of last year.

[*Note*. This will usually be brief, as the Report will, as a rule, be accompanied by the Chairman's review.]

Adequate provision has been made for all contingencies before arriving at the profits for the year.

Messrs. A. LIGHT and B. SOUND retire from the Board by rotation, but, being eligible, offer themselves for re-election.

The auditors, Messrs. A. LERT & Co., are willing to continue in office.

It is proposed to post the Dividend Warrants on 15th August, 19...

On behalf of the Board,
D. HEAT,
30th June, 19... *Chairman*.

The Balance Sheet must be signed by two of the directors or the sole director (Sect. 155) and the Directors' Report (Sect. 157), Profit and Loss Account and Auditors' Report (Sect. 156) must be attached.

A copy of the Balance Sheet and Profit and Loss Account (with group accounts if applicable) together with all documents required by law to be annexed thereto, must be sent to all the members and debenture-holders not less than twenty-one days before the meeting takes place (Sect. 158). If sent less than twenty-one days before the meeting, it will be deemed to have been duly circulated if all members entitled to attend and vote so agree (Sect. 158 (1) (*c*)). The above requirements apply equally to private as well as public companies.

Where a company has subsidiaries, group accounts must be circulated to members and laid before the company in Annual General Meeting, subject to certain exceptions, e.g. where the company is itself a wholly-owned subsidiary of a body corporate in Great Britain.

Auditors. Sect. 162 of the Companies Act, 1948, provides—

(1) The auditors shall make a report to the members on the accounts examined by them, and on every Balance Sheet, every Profit and Loss Account, and all group accounts laid before the company in general meeting during their tenure of office, and the report shall contain statements as to the matters mentioned in the *Ninth Schedule* to this Act.

(2) The auditors' report shall be read before the company in general meeting and shall be open to inspection by any member.

(3) Every auditor of a company shall have a right of access at all times to the books and accounts and vouchers of the company, and shall be entitled to require from the officers of the company such information and explanation as he thinks necessary for the performance of the duties of the auditors.

(4) The auditors of a company shall be entitled to attend any general

meeting of the company, and to receive all notices of and other communications relating to any general meeting which any member of the company is entitled to receive and to be heard at any general meeting which they attend on any part of the business of the meeting which concerns them as auditors.

The ninth schedule (see Sect. 162 (1) above) provides that the auditors shall state expressly in their report—

(1) Whether they have obtained all the information and explanations which to the best of their knowledge and belief were necessary for the purposes of their audit.

(2) Whether, in their opinion, proper books of account have been kept by the company, so far as appears from their examination of those books, and proper returns adequate for the purposes of their audit have been received from branches not visited by them.

(3)—(1) Whether the company's Balance Sheet and (unless it is framed as a consolidated Profit and Loss Account) Profit and Loss Account dealt with by the report are in agreement with the books of account and returns.

(2) Whether, in their opinion and to the best of their information and according to the explanations given them, the said accounts give the information required by the Act in the manner so required and give a true and fair view—

(*a*) in the case of the Balance Sheet, of the state of the company's affairs as at the end of its financial year; and

(*b*) in the case of the Profit and Loss Account, of the profit or loss for its financial year;

or, as the case may be, give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Eighth Schedule to this Act are not required to be disclosed.

Furthermore subsection (8) of Sect. 196, which requires disclosure of the amounts of Directors' Emoluments, Salaries, Pensions, Compensation, etc. [see page 794], provides that—

If in the case of any accounts the requirements of this section are not complied with, it shall be the duty of the auditors of the company by whom the accounts are examined to include in their report thereon, so far as they are reasonably able to do so, a statement giving the required particulars.

Reserve Liability. This term (which is to be seen on the liabilities side of the Balance Sheet of some limited companies) is given to that part of the subscribed capital of a limited company that can only be called up in the event of, and for the purpose of, liquidation. Under Sect. 60, Companies Act, 1948, a company may, by special resolution, take power to determine that a specified part of each share shall remain uncalled, except for the above-mentioned purpose.

A considerable reserve liability is maintained by most of the large banks for the protection of depositors.

The Statutory Report and Meeting. Every *public* company which has a share capital, whether limited by shares or guarantee, must

hold a general meeting of the company not less than one, and not more than three, months from the date at which the company is entitled to commence business. (Sect. 130 (1).)

At least FOURTEEN DAYS before this meeting the directors must forward to every member of the company a copy of the statutory report.

The statutory report must be certified by NOT less than TWO directors of the company, or where there are less than two directors, by the sole director and manager. It must contain the following—

(i) The total number of shares allotted, distinguishing shares allotted as fully or partly paid up otherwise than in cash, and stating in the case of shares partly paid up the extent to which they are paid up, and in either case the consideration for which they were allotted.

(ii) The total amount of cash received by the company in respect of all the shares allotted, distinguished as in (i) above.

(iii) An abstract of the receipts and payments of the company made up to a date within SEVEN DAYS of the DATE OF THE REPORT, showing under separate headings the receipts in respect of shares and *debentures* and *other* sources, and the payments thereout, and the particulars of the balance in hand.

(iv) An account or estimate of the preliminary expenses of the company.

(v) The names, addresses, and descriptions of the directors, auditors (if any), managers (if any), and secretary of the company.

(vi) The particulars of any contract, the modification of which is to be submitted to the meeting for its approval, together with the particulars of the modification or proposed modification.

The statutory report shall, so far as it relates to the shares allotted by the company, and to the cash received in respect of such shares, and to the receipts and payments of the company on **capital** account, be certified as correct by the auditors, if any, of the company. The above provisions do NOT apply to a **private** company.

Illustration. On 1st January a company was formed under the name of Stationers Co., Ltd., to take over the business of A. Page, wholesale stationer. On 15th January a prospectus was issued by the company inviting applications for 90,000 shares of £1 each payable 5s. on application, 5s. on allotment, and 5s. three months after allotment, and 5s. six months after allotment; the vendor was to receive 10,000 fully paid shares as part discharge of the purchase consideration of £40,000. The offer was fully subscribed, and the vendor duly paid.

The trading receipts to 3rd March amounted to £10,500 and trading payments to the same date £1,800; the date to which the Cash Account is drawn is 3rd March.

The preliminary expenses amounted to £4,500, and it was estimated that they would eventually reach £7,000.

A further £16,000 was expended on 1st March on the purchase of additional plant.

The company received the certificate entitling it to commence business on 26th January, the statutory meeting being held on 21st March, and the report dated 6th March.

THE COMPANIES ACT, 1948

No. of Company........................

REPORT pursuant to Sect. 130 of the Companies Act, 1948, of ....
........................*Stationers Company*, ...Limited.

(*a*) The total number of shares allotted is . ...*100,000* . .. ..of which ....*10,000*...........are allotted ....*as fully paid up in consideration of part of the purchase price of sundry assets acquired by the company* .... and upon each of the remaining shares the sum of.... ....*10s*.............has been paid in cash.

(*b*) The total amount of cash received by the Company in respect of the shares issued wholly for cash is .... *£45,000* ....and on the shares issued partly for cash is £ ....*nil* ....

(*c*) The Receipts and Payments of the Company to the Third day of March are as follows—

Particulars of Receipts		Particulars of Payments	
	£		£
To Amount Received on Application and Allotment of 90,000 shares	*45,000*	*By Preliminary Expenses*	*4,500*
„ Trading Receipts	*10,500*	*„ Purchase of Plant*	*16,000*
		„ Vendor	*30,000*
		„ Trading Payments	*1,800*
		„ Balance on Deposit and Current Accounts at the Central Bank, Ltd.	*3,200*
	£55,500		*£55,500*

The following is an account (estimate) of the Preliminary Expenses of the Company—

	£
Contract Stamps, Solicitors' Fees, etc.	*£7,000*

(*d*) Names, Addresses, and Descriptions of the Directors, Auditors (if any) managers (if any), and Secretary of the Company—

Surname	Christian Name	Address	Description

(*e*) Particulars of any Contract the modification of which is to be submitted to the Meeting for its approval, together with particulars of the modification or proposed modification—

....

....

We hereby certify this Report,

.... } Directors.
....

We hereby certify that so much of this Report as relates to the shares allotted by the Company and to the Cash received in respect of such shares and to the receipts and payments of the Company on Capital Account is correct.

....
Auditors.

Dated this... ... *Sixth*... ... day of... ... *March*,... ... 19. . .

Statutory Books. The statutory books are—

(*a*) Register of members. (*b*) Annual return. (*c*) Minute book.

(*d*) Register of directors and their shareholdings.

(*e*) Register of charges.

(*f*) A copy of every instrument creating a CHARGE, although this is not strictly a book; but if a debenture is issued without conferring upon the lender any charge (which includes mortgage) there is no compulsion to keep a debenture register.[1]

Register of Members. A person acquiring shares becomes a member of the company on the date of the entry into the register, except for the signatories to the memorandum who become members from the date of incorporation of the company.

A member ceases to be such upon the date of the entry of cessation in the register.

A person may become (or cease to be) a member by transfer or transmission; become a member by allotment; and cease to be a member by surrender, forfeiture, rescission, repudiation, expropriation, enforcement by the company of its lien, and by the winding-up of the company.

The Register which contains the details required by the Companies Act, 1948, must be kept open at the prescribed office for inspection by members (gratis) and other persons (upon payment).

The office above mentioned is (*a*) the Registered Office of the company, (*b*) that where the work of making up the register is done, or (*c*), where the work of making it up is done by an agent, e.g. Registrar employed by the company, at that agent's office.

The Register must be kept in England by an English Company and in Scotland by a Scottish Company. The Registrar of Companies must be notified of the place where the Register of members is kept and of any change in that place, unless it has always been and is still kept at the Registered office (Sect. 110).

[1] Whether the debenture is secured or not, there is no legal necessity to keep a register of debenture-holders, although this will usually be essential in practice. If one is kept, Sections 86 and 87 of the Act apply.

Annual Return. The return must be made within forty-two days after the annual general meeting (whether or not that meeting is the first or only ordinary general meeting, or the first or only general meeting of that year) and forwarded to the Registrar of Companies *forthwith* (Sect. 126).

If a company has a share capital, it must in every year make a return of all persons who, on the fourteenth day after the annual general meeting of the company for the year, are members of the company and of all persons who ceased to be members since the date of the last return.

The company need not make up an annual return in the year of its incorporation, or, if it is not required to hold an annual general meeting during the following year, in *that* year (Sect. 124).

The return is required from *all* companies—public and private—and, except for exempt private companies, must include—

(*a*) A written and certified true copy of every Balance Sheet laid before the company in general meeting **during the period** to which the return relates, and

(*b*) A copy of the Directors' Report accompanying any such Balance Sheet (and prescribed annexable documents) certified in the same way as the Balance Sheet.

The Annual Return, the certificate as to any Balance Sheet included therein, and any certificate as to the annual return of a private company must be signed by *both* a director and the secretary of the Company (Sects. 127 and 128).

The Annual Return of an exempted private company must include a certificate, signed by the persons signing the other certificates on the return, stating that to the best of their knowledge and belief the conditions as to exemption have been satisfied (Sect. 129).

Minute Book. The Companies Act, 1948 (Sects. 145 and 146), requires the keeping and availability for inspection by members, of a book containing the minutes of every general meeting of the COMPANY; in addition, there must be a Minute Book of the directors—not available for general inspection. It should be observed that where a company adopts Table A it must keep a DIRECTORS ATTENDANCE BOOK.

An auditor is entitled to inspect the minute books at any time.

Register of Directors. This book contains the prescribed details of directors and secretary, and may be kept at a place other than the REGISTERED OFFICE of the company.

Register of Directors' Shareholdings. Every company is required to keep a register of Directors' shareholdings showing the number, description and amount of shares in or debentures of the company or other body corporate, being the company's subsidiary or holding company or a subsidiary of the company's holding company, held *by* or *in trust for* each director, or of which he has any right to *become* the holder (except as to shares in a body corporate which is a wholly owned subsidiary of another body corporate).

The nature and extent of a directors' interest in or rights over the shares or debentures recorded against his name in the register shall, if he so requires, be indicated in the register.

The register must be kept at the registered office and open for at least two hours per day during business hours fourteen days before the company's annual general meeting and three days thereafter for inspection by a member or debenture-holder: and by the Board of Trade without restrictions as to period. The register must be produced and remain accessible at the annual general meeting to any person attending the meeting (Sect. 195).

Register of Charges. A charge created by the company for or in respect of the following purposes or matters must be entered in the register, and the prescribed details thereof filed with the Registrar of Companies within 21 days of creation of the charge—

(*a*) For the purpose of securing any issue of debentures.

(*b*) A charge on uncalled share capital of the company.

(*c*) A charge created or evidenced by an instrument which, if executed by an individual, needs registration as a bill of sale.

(*d*) A charge on land, wherever situate, or any interest therein (except for a charge for any rent or other periodical sum issuing out of land).

(*e*) A charge on book debts of the company.

(*f*) A floating charge on the undertaking or property of the company.

(*g*) A charge on calls made but not paid.

(*h*) A charge on a ship or share in a ship.

(*i*) A charge on goodwill, a patent or licence under a patent, trade-mark, copyright, or licence under copyright (Sect. 95).

Briefly, the failure to file invalidates the *security*, but not the *debt*, with the result that the creditor is on the same "level" as unsecured creditors of the company.

Statistical Books. The statistical books of a company will vary according to circumstances, e.g. nature of the business, frequency of meetings, and the number of members. The following list, whilst not exhaustive, contains the chief statistical books. There is no legal compulsion to keep books under this heading.

Register of debenture-holders (compulsory if Table A is adopted) or debenture stockholders.

Interest on debentures register. Register of transfers.

Registers and documents relating to issue of shares, e.g.—

Application sheets.	Allotment sheets.	Calls.
Share certificates.	Transfers.	Transfer fees.
Notices in lieu of distringas.		Powers of attorney.
Certification.	Probate.	Sealed documents.

Directors' Attendance Book (optional unless Table A is adopted).
Dividends Register. Agenda Book.

The chief documents to be filed with the Registrar of Companies are—

1. Those required on incorporation. (See Chapter XXIII (*f*).)

2. Prospectus or statement in lieu of prospectus. (Public Companies.)

3. Return of particulars of directors and secretaries (within 14 days of appointment of first directors).

4. Return of changes in the list of directors and secretaries (within 14 days of such change).

5. A return of details of the allotment of shares WITHIN ONE MONTH. If the shares are issued otherwise than for cash, particulars of the consideration therefor must be stated, and in addition—

6. The contract evidencing the allotment, or if not already embodied in writing, the prescribed particulars of the contract.

7. In respect of charges—

(*a*) Certain details WITHIN 21 DAYS of creation of charge. (*b*) Memorandum of satisfaction of charge together with declaration of verification.

8. In respect of capital changes—

(*a*) Notice of consolidation, subdivision, conversion of shares into stock or stock into shares. (*b*) Notice of increase. (*c*) Copy of Court Order authorizing reorganization or reduction.

9. Statutory Report.

10. Copy of every extraordinary or special resolution within 15 DAYS of its being passed.

11. The Annual Return.

Specimen Rulings and Forms.

Specimens are now shown of the rulings of the more important books, etc., referred to in this chapter.

REGISTER OF MEMBERS AND SHARE LEDGER

Name.. Date of Entry as a Member ....19...

Address.. Date of Ceasing to be a Member..19....

Dr. Shares Acquired										*Dr.* Cash Payable on Shares						Cash Paid on Shares *Cr.*						Shares Transferred *Cr.*								
No. of Allotment	No. of Transfer	Date of Allotment or Entry of Transfer	No. of Shares Allotted or Transferred	Distinctive Numbers (inclusive)		Transferor's Folio (if so Acquired)	Total Value of Shares Held			Date when Called	Description of Payment of No. of Call	Amount per Share	Total Amount			Date when Due	Date of Payment	Cash Book Folio	Amount			No. of Transfer	Date of Entry of Transfer	No. of Shares Transferred	Distinctive Numbers (inclusive)		Transferee's Folio	Total Value of Shares Transferred		
				From	To		£	s.	d.			£	£	s.	d.				£	s.	d.				From	To		£	s.	d.

TRANSFER REGISTER

Date when Lodged	Number of Transfer	Number of Old Certificate	Folio in Register of Members	Transferor's		Transferee's		Folio in Register of Members	Number of Shares Transferred	Number of New Certificate	Distinctive Numbers of Shares Transferred	Folio in Register of Members	Transfer Value
				Name	Address	Name	Address						

REGISTER OF CHARGES

No. of Charge	Date of Charge	Brief Description of the Property Charged	Rate of Interest	Amount of the Charge	Persons Entitled to Charge		Date Filed with Registrar	Date of Memorandum of Satisfaction
					Name	Address		
				£				

REGISTER OF SHARE WARRANTS

Date of Application	No. of Warrant	To Whom Issued	Particulars of Shares, etc., Exchanged						Warrants Surrendered				
			Shares Exchanged				Stock Exchanged		Nos. of Warrants		By Whom Surrendered	Ledger Folio	Date of Surrender
			Folio of Share Register	No. of Shares	Distinctive Numbers		Folio of Stock Ledger	Amount	From	To			
					From	To							
								£ s. d.					

THIS FORM MUST BE FORWARDED ENTIRE TOGETHER WITH REMITTANCE TO THE COMPANY'S BANKERS CENTRAL BANK LTD HATTON STREET, MANCHESTER WHO WILL RETURN IT DULY RECEIPTED CHEQUES TO BE MADE PAYABLE TO PITCH BLACK LTD, AND CROSSED "NOT NEGOTIABLE"

PITCH BLACK, LTD.

(Incorporated under the Companies Act, 1948)

ISSUE OF 30,000 ORDINARY SHARES OF £1 EACH

No *25*

ALLOTMENT LETTER

65 BARKER'S LANE,
MANCHESTER.
28th April, 19..

C. Light, Esq.,
10 Dark Lane,
Heaton

SIR (MADAM),

In reference to your application, I am pleased to inform you that *.2,000* Ordinary Shares of £1 each in the Capital of the above Company have been allotted to you by the directors.

	£	s	d
The amount payable on application and allotment, viz *7s 6d* per share on *2,000* shares is .	*750*	–	–
You have already paid on application	*250*	–	–
Making the amount due from you upon allotment	*£500*	–	–

This amount is now due from you, and should be paid forthwith to the Company's Bankers, the Central Bank, Ltd., Hatton Street, Manchester. Due notice will be given when the share certificates are ready, and they will then only be delivered in exchange for this letter, accompanied by the receipts from the Bankers for the amounts paid on application and allotment.

BY ORDER OF THE BOARD,

Secretary

(Perforation)

BANKERS' RECEIPT FOR ALLOTMENT MONEY

PITCH BLACK LTD

RECEIVED this *Fifth* day of *May,* 19 , the sum of *£500* , due in respect of allotment No *25*

Stamp Cashier

(Perforation)

PITCH BLACK, LTD.

(This slip to be detached and retained by Bankers)

No *25* Amount *£500*

Fifth day of *May,* 19

Shares forwarded to the Company's Office by

CERTIFICATE for

TRANSFER FORM

I,

in * consideration of the sum of

paid by

hereinafter called the Transferee,

DO hereby bargain, sell, assign and transfer, to the said Transferee

of and in the undertaking called

TO HOLD unto the said Transferee, Executors, Administrators and Assigns, subject to the several conditions on which held the same immediately before the execution hereof, and the said Transferee, do hereby agree to accept and take the said subject to the conditions aforesaid.

AS WITNESS our Hands and Seals this day of in the year of our Lord, One thousand nine hundred

SIGNED, sealed, and delivered by the above-named in the presence of
† Witness's Signature
Address
Occupation
Seal

SIGNED, sealed, and delivered by the above-named in the presence of
† Witness's Signature
Address
Occupation
Seal

SIGNED, sealed, and delivered by the above-named in the presence of
† Witness's Signature
Address
Occupation
Seal

SIGNED, sealed, and delivered by the above-named in the presence of
† Witness's Signature
Address
Occupation
Seal

SIGNED, sealed, and delivered by the above-named in the presence of
† Witness's Signature
Address
Occupation
Seal

* The Consideration-money set forth in a Transfer may differ from that which the first seller will receive, owing to sub-sales by the original Buyer; the Stamp Act requires that in such cases the consideration-money paid by the Sub-purchaser shall be the one inserted in the Deed, as regulating the *ad valorem* Duty; the following is the *Clause* in question—

"Where a person, having contracted for the purchase of any Property, but not having obtained a Conveyance thereof, contracts to sell the same to any other person, and the Property is in consequence conveyed immediately to the Sub-purchaser, the Conveyance is to be charged with *ad valorem* Duty in respect of the Consideration moving from the Sub-purchaser."—(54 & 55, Vic., cap. 39, sec. 58, sub-sec. 4.)

Instructions for executing Transfers.

† *When a Transfer is executed out of Great Britain it is recommended that the Signatures be attested by H.M. Consul or Vice-Consul, a Clergyman, Magistrate, Notary Public, or by some other Person holding a public position—as most Companies refuse to recognize Signatures not so attested. When a Witness is a Female she must state whether she is a Spinster, Wife, or Widow; and if a Wife she must give her husband's Name, Address and Quality, Profession or Occupation. The Date must be inserted in Words and not in Figures.*

Where the Transfer is made for a nominal consideration and is required to be stamped with the fixed duty of 10s. the following Certificate must be filled up and signed.

By (1) both transferor and transferee, or (2) a Solicitor or a member of a Stock Exchange acting for one or other of the parties, or (3) an accredited representative of a Bank. In the case of (3) the certificate may, where the Bank or its official nominee is a party to the transfer, be to the effect that "the transfer is excepted from Section 74 of the Finance (1909/10) Act, 1910."

I HEREBY CERTIFY that this Transfer is made on the occasion of—

(*a*) On the appointment of a new trustee of a pre-existing trust, or on the retirement of a trustee.

(*b*) A transfer as for a nominal consideration to a mere nominee of the transferor where no beneficial interest in the property passes.

(*c*) A security for a loan; or a re-transfer to the original transferor on repayment of a loan.

(*d*) A transfer to a residuary legatee of stock, etc., which forms part of the residue divisible under a Will.

(*e*) A transfer to a beneficiary under a Will of a *specific* legacy of Stock, etc.

(*f*) A transfer of Stock, etc., being the property of a person dying intestate to the party or parties entitled to it.

(*g*) A transfer to a beneficiary under a settlement, on distribution of the trust funds, of Stock, etc., forming the share, or part of the share, of those funds to which the beneficiary is entitled in accordance with the terms of the settlement.

Strike out all those clauses not applicable.

Dated this day of 19..

Signed

Address

[Various declarations and certificates under the Exchange Control Act, 1947, must also be annexed.]

CONTENTS OF THE BALANCE SHEET AND ACCOUNTS

The Companies Act, 1929, introduced for the first time in the history of Company Law numerous provisions concerning disclosure of information in the published accounts of limited companies.

Subsequent events have shown that those provisions were not sufficiently comprehensive to give that amount of information which, particularly having regard to the continued growth of holding companies, is regarded as necessary to serve the public need.

The constant endeavours of the Professional Accountants' organizations to set a standard of good accounting practice and the recommendations of the Cohen Committee bore fruit in the passing of the Companies Act, 1947, which embodied in the main the recommendations and suggestions so made.

The provisions of the 1947 Act, together with many of the 1929 Act, are now consolidated in the Companies Act, 1948 and are, so far as they are of an accounting nature, given in the succeeding pages. It is important to observe that—

(1) the accounting provisions generally concern the accounts of all limited companies, and

(2) in addition, certain provisions concern the accounts of holding companies and subsidiaries. These are dealt with in detail in the next chapter.

General

(A) Every Balance Sheet of a company shall give a true and fair view of the state of affairs of the company as at the end of its financial year, and every Profit and Loss Account of a company shall give a true and fair view of the profit or loss of the company for the financial year. (Sect. 149 (1).)

A company's Balance Sheet and Profit and Loss Account shall comply with the requirements of the Eighth Schedule to this Act, so far as applicable thereto. (Sect. 149 (2).)

The Board of Trade may, on the application or with the consent of a company's directors, modify in relation to that company any of the requirements of this Act as to the matters to be stated in a company's Balance Sheet or Profit and Loss Account (except the requirements of subsection (1) of this section) for the purpose of adapting them to the circumstances of the company. (Sect. 149 (4).)

Subsections (1) and (2) of this section shall not apply to a company's Profit and Loss Account, if—

(*a*) The company has subsidiaries; and

(*b*) The Profit and Loss Account is framed as a consolidated Profit and Loss Account dealing with all or any of the company's subsidiaries as well as the company, and—

(i) complies with the requirements of this Act relating to consolidated Profit and Loss Accounts; and

(ii) shows how much of the consolidated profit or loss for the financial year is dealt with in the accounts of the company. (Sect. 149 (5).)

(B) The Profit and Loss Account and, so far as not incorporated in the Balance Sheet or Profit and Loss Account, any group accounts laid before a company in general meeting shall be annexed to the Balance Sheet and approved by the board of directors before the Balance Sheet is signed on their behalf. The auditors' report shall be attached thereto. (Sect. 156 (1) and (2).)

Every Balance Sheet of a company shall be signed on behalf of the board by two of the directors of the company, or, if there is only one director, by that director.

In the case of a banking company registered after the fifteenth day of August, eighteen hundred and seventy-nine, the Balance Sheet must be signed by the secretary or manager, if any; and where there are more than three directors of the company by at least three of those directors, and where there are not more than three directors by all the directors. (Sect. 155 (1) and (2).)

(C) The authorized share capital, issued share capital, liabilities and assets shall be summarized, with such particulars as are necessary to disclose the general nature of the assets and liabilities, and there shall be specified—

(*a*) Any part of the issued capital that consists of redeemable preference shares, and the earliest date on which the company has power to redeem those shares.

(*b*) So far as the information is not given in the Profit and Loss Account, any share capital on which interest has been paid out of capital during the financial year, and the rate at which interest has been so paid.

(*c*) The amount of the Share Premium Account.

(d) Particulars of any redeemed debentures which the company has power to reissue. (Para. 2, Part I, 8th Sch.)

(D) The reserves, provisions, liabilities, and fixed and current assets shall be classified under headings appropriate to the company's business—

Provided that—

(a) Where the amount of any class is not material, it may be included under the same heading as some other class; and

(b) Where any assets of one class are not separable from assets of another class, those assets may be included under the same heading. (Para. 4 (1), Part I, 8th Sch.)

(E) (1) For the purposes of this Schedule, unless the context otherwise requires—

(a) The expression "provision" shall, subject to sub-paragraph (2) of this paragraph, mean any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability of which the amount cannot be determined with substantial accuracy;

(b) The expression "reserve" shall not, subject as aforesaid, include any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets or retained by way of providing for any known liability;

(c) The expression "capital reserve" shall not include any amount regarded as free for distribution through the Profit and Loss Account, and the expression "revenue reserve" shall mean any reserve other than a capital reserve;

and in this paragraph the expression "liability" shall include all liabilities in respect of expenditure contracted for and all disputed or contingent liabilities.

(2) Where—

(a) Any amount written off or retained by way of providing for depreciation, renewals or diminution in value of assets, not being an amount written off in relation to fixed assets before the coming into force of this Act;[1] or

(b) Any amount retained by way of providing for any known liability; is in excess of that which in the opinion of the directors is reasonably necessary for the purpose, the excess shall be treated for the purposes of this Schedule as a reserve and not as a provision. (Para. 27, Part IV, 8th Sch.)

Share Capital

(A) (1) Where a company issues shares at a premium, whether for cash or otherwise, a sum equal to the aggregate amount or value of the premiums on those shares shall be transferred to an account, to be called "the Share Premium Account," and the provisions of this Act relating to the reduction of the share capital of a company shall, except as provided in this section, apply as if the Share Premium Account were paid up share capital of the company.

(2) The Share Premium Account may, notwithstanding anything in the foregoing subsection, be applied by the company in paying up unissued shares of the company to be issued to members of the company as fully-paid bonus shares, in writing off—

(a) The preliminary expenses of the company; or

(b) The expenses of, or the commission paid or discount allowed on, any issue of shares or debentures of the company;

or in providing for the premium payable on redemption of any redeemable preference shares or of any debentures of the company.

(3) Where a company has before the commencement of this Act[1] issued any shares at a premium, this section shall apply as if the shares had been issued after the commencement of this Act:

[1] 1st July, 1948.

Provided that any part of the premiums which has been so applied that it does not at the commencement of this Act[1] form an identifiable part of the company's reserves within the meaning of the Eighth Schedule to this Act shall be disregarded in determining the sum to be included in the share premium account. (Sect. 56.)

(B) Redeemable Preference Shares—see page 870.

(C) Interest on Construction Capital—see page 944.

Assets

(A) (1) Fixed assets shall also be distinguished from current assets.

(2) The method or methods used to arrive at the amount of the fixed assets under each heading shall be stated. (Para. 4 (2) and (3), Part I, 8th Sch.)

(B) (1) The method of arriving at the amount of any fixed asset shall, subject to the next following sub-paragraph, be to take the difference between:

(*a*) Its cost or, if it stands in the company's books at a valuation, the amount of the valuation; and

(*b*) The aggregate amount provided or written off since the date of acquisition or valuation, as the case may be, for depreciation or diminution in value;

and for the purposes of this paragraph the net amount at which any assets stand in the company's books at the commencement of this Act[1] (after deduction of the amounts previously provided or written off for depreciation or diminution in value) shall, if the figures relating to the period before the commencement of this Act cannot be obtained without unreasonable expense or delay, be treated as if it were the amount of a valuation of those assets made at that date and, where any of those assets are sold, the said net amount less the amount of the sales shall be treated as if it were the amount of a valuation so made of the remaining assets.

(2) The foregoing sub-paragraph shall not apply—

(*a*) To assets for which the figures relating to the period beginning with the commencement of this Act[1] cannot be obtained without unreasonable expense or delay; or

(*b*) To assets, the replacement of which is provided for wholly or partly by making provision for renewals and charging the cost of replacement against the provision so made; or by charging the cost of replacement direct to revenue; or

(*c*) To any investments of which the market value (or, in the case of investments not having a market value, their value as estimated by the directors) is shown either as the amount of the investments or by way of note; or

(*d*) To goodwill, patents or trade marks.

(3) For the assets under each heading whose amount is arrived at in accordance with sub-paragraph (1) of this paragraph, there shall be shown—

(*a*) The aggregate of the amounts referred to in paragraph (*a*) of that sub-paragraph; and

(*b*) The aggregate of the amounts referred to in paragraph (*b*) thereof.

(4) As respects the assets under each heading whose amount is not arrived at in accordance with the said sub-paragraph (1) because their replacement is provided for as mentioned in sub-paragraph (2) (*b*) of this paragraph, there shall be stated—

(*a*) The means by which their replacement is provided for; and

(*b*) The aggregate amount of the provision (if any) made for renewals and not used. (Para. 5, Part I, 8th Sch.)

Investments

There shall be shown under separate headings the aggregate amounts respectively of the company's trade investments, quoted investments other than trade investments, and unquoted investments other than trade investments. (Para. 8 (1) (*a*), Part I, 8th Sch.)

[1] 1st July, 1948.

The heading showing the amount of the quoted investments other than trade investments shall be subdivided, where necessary, to distinguish the investments as respects which there has, and those as respects which there has not, been granted a quotation or permission to deal on a recognized stock exchange. (Para. 8 (3), Part I, 8th Sch.)

For the purposes aforesaid, the expression "quoted investment" means an investment as respects which there has been granted a quotation or permission to deal on a recognized stock exchange, or on any stock exchange of repute outside Great Britain, and the expression "unquoted investment" shall be construed accordingly. (Para. 28, Part IV, 8th Sch.)

Goodwill, Patents and Trade-marks

(A) There shall be shown under a separate heading . . . if the amount of the goodwill and of any patents and trade-marks or part of that amount is shown as a separate item in or is otherwise ascertainable from the books of the company, or from any contract for the sale or purchase of any property to be acquired by the company, or from any documents in the possession of the company relating to the stamp duty payable in respect of any such contract or the conveyance of any such property, the said amount so shown or ascertained so far as not written off or, as the case may be, the said amount so far as it is shown or ascertainable and as so shown or ascertained, as the case may be. (Para. 8 (1)(*b*), Part I, 8th Sch.)

(B) Nothing in the foregoing sub-paragraph shall be taken as requiring the amount of the goodwill, patents and trade-marks to be stated otherwise than as a single item. (Para. 8 (2), Part I, 8th Sch.)

Liabilities

(A) Where any liability of the company is secured otherwise than by *operation of law* on any assets of the company, the Balance Sheet shall include a statement that that liability is so secured, but it shall not be necessary to specify in the Balance Sheet the assets on which the liability is secured. (Para. 9, Part I, 8th Sch.)

[Operation of Law—where a creditor in addition to being able to sue for the debt has also the right to some type of security given to him under statute or by the general body of law, e.g. (1) lien of an unpaid vendor; (2) charge on a house or land by a local authority in respect of road-making charges.]

(B) Where a company has power to re-issue debentures which have been redeemed, particulars with respect to the debentures which can be so re-issued shall be included in every Balance Sheet of the company. (*Vide* Para. 2 (*d*), Part I, 8th Sch.)

(C) Where any of the company's debentures are held by a nominee of or trustee for the company, the nominal amount of the debentures and the amount at which they are stated in the books of the company shall be stated. (Para. 10, Part I, 8th Sch.)

(D) There shall be shown under a separate heading the aggregate amount of bank loans and overdrafts. (Para. 8 (1) (*d*), Part I, 8th Sch.)

Reserves and Provisions[1]

(A) The aggregate amounts respectively of capital reserves, revenue reserves, and provisions (other than provisions for depreciation, renewals or diminution in value of assets) shall be stated under separate headings—

Provided that:

(*a*) This paragraph shall not require a separate statement of any of the said three amounts which is not material; and

(*b*) The Board of Trade may direct that it shall not require a separate statement of the amount of provisions where they are satisfied that that is not required in the public interest and would prejudice the company, but subject to the condition that any heading stating an amount arrived

[1] See page 787 for definitions.

at after taking into account a provision (other than as aforesaid) shall be so framed or marked as to indicate that fact. (Para. 6, Part I, 8th Sch.)

(B) (1) There shall also be shown (unless it is shown in the Profit and Loss Account or a statement or report annexed thereto, or the amount involved is not material)—

(*a*) Where the amount of the capital reserves, of the revenue reserves or of the provisions (other than provisions for depreciation, renewals or diminution in value of assets) shows an increase as compared with the amount at the end of the immediately preceding financial year, the source from which the amount of the increase has been derived; and

(*b*) Where the amount of the capital reserves or of the revenue reserves shows a decrease as compared with the amount at the end of the immediately preceding financial year; or the amount at the end of the immediately preceding financial year of the provisions (other than provisions for depreciation, renewals or diminution in value of assets) exceeded the aggregate of the sums since applied and amounts still retained for the purposes thereof; the application of the amounts derived from the difference.

(2) Where the heading showing any of the reserves or provisions aforesaid is divided into sub-headings, this paragraph shall apply to each of the separate amounts shown in the sub-headings instead of applying to the aggregate amount thereof. (Para. 7, Part I, 8th Sch.)

Preliminary and Issue Expenses

There shall be stated under separate headings, so far as they are not written off—

(*a*) The preliminary expenses.

(*b*) Any expense incurred in connection with any issue of share capital or debentures.

(*c*) Any sums paid by way of commission in respect of any shares or debentures.

(*d*) Any sums allowed by way of discount in respect of any debentures and

(*e*) The amount of the discount allowed on any issue of shares at a discount. (Para. 3, Part I, 8th Sch.)

Proposed Dividend

There shall be stated under a separate heading in the Balance Sheet the net aggregate amount (after deduction of income tax) which is recommended for distribution by way of dividend. (Para. 8 (1) (*e*), Part I, 8th Sch.)

Subsidiary Companies

Where any of the assets of a company consist of shares in, or amounts owing (whether on account of a loan or otherwise) from a subsidiary company or subsidiary companies, the aggregate amount of those assets, distinguishing shares from indebtedness, shall be set out in the Balance Sheet of the first mentioned company separately from all its other assets, and where a company is indebted, whether on account of a loan or otherwise, to a subsidiary company or subsidiary companies, the aggregate amount of that indebtedness shall be set out in the Balance Sheet of that company separately from all its other liabilities. (Para. 15 (2), Part II, 8th Sch.)

See also next chapter for detailed requirements, group accounts, etc.

Balance Sheet Notes

(1) The matters referred to in the following sub-paragraphs shall be stated by way of note, or in a statement or report annexed, if not otherwise shown

(2) The number, description, and amount of any shares in the company which any person has an option to subscribe for, together with the following particulars of the option, that is to say—

(*a*) The period during which it is exercisable.

(*b*) The price to be paid for shares subscribed for under it.

(3) The amount of any arrears of fixed cumulative dividends on the company's shares and the period for which the dividends or, if there is more than one class, each class of them are in arrear, the amount to be stated *before* deduction of income tax, except that, in the case of tax free dividends, the amount shall be shown free of tax and the fact that it is so shown shall also be stated.

(4) Particulars of any charge on the assets of the company to secure the liabilities of any other person, including, where practicable, the amount secured.

(5) The general nature of any other contingent liabilities not provided for and, where practicable, the aggregate amount or estimated amount of those liabilities, if it is material.

(6) Where practicable, the aggregate amount or estimated amount, if it is material, of contracts for capital expenditure, so far as not provided for.

(7) If in the opinion of the directors any of the current assets have not a value, on realization in the ordinary course of the company's business, at least equal to the amount at which they are stated, the fact that the directors are of that opinion.

(8) The aggregate market value of the company's quoted investments, other than trade investments, where it differs from the amount of the investments as stated, and the Stock Exchange value of any investments of which the market value is shown (whether separately or not) and is taken as being higher than their Stock Exchange value.

(9) The basis on which foreign currencies have been converted into sterling, where the amount of the assets or liabilities affected is material.

(10) The basis on which the amount, if any, set aside for United Kingdom income tax is computed.

(11) Except in the case of the first Balance Sheet laid before the company after the coming into force of this Act,[1] the corresponding amounts at the end of the immediately preceding financial year for all items shown in the Balance Sheet. (Para. 11, Part I, 8th Sch.)

Loans to Employees for Purchase of Shares in the Company

Subject as provided in this section, it shall not be lawful for a company to give, whether directly or indirectly, and whether by means of a loan, guarantee, the provision of security or otherwise, any financial assistance for the purpose of or in connection with a purchase or subscription made or to be made by any person of any shares in the company; or where the company is a subsidiary company, in its holding company.

Provided that nothing in this section shall be taken to prohibit—

(*a*) Where the lending of money is part of the ordinary business of a company, the lending of money by the company in the ordinary course of its business.

(*b*) The provision by a company, in accordance with any scheme for the time being in force, of money for the purchase by trustees of fully-paid shares in the company to be held by or for the benefit of employees of the company, including any director holding salaried employment or office in the company.

(*c*) The making by a company of loans to persons, other than directors, *bona fide* in the employment of the company with a view to enabling those persons to purchase fully-paid shares in the company to be held by themselves by way of beneficial ownership. (Sect. 54 (1).)

The aggregate amount of any outstanding loans made under the authority of provisos (*b*) and (*c*) to sub-section (1) of Section 54 of this Act shall be shown as a separate item in every Balance Sheet of the company. (Para. 8 (1) (*c*), Part I, 8th Sch.)

[1] 1st July, 1948.

Items to be shown in the Profit and Loss Account

(1) There shall be shown—

(*a*) The amount charged to revenue by way of provision for depreciation, renewals or diminution in value of fixed assets.

(*b*) The amount of the interest on the company's debentures and other fixed loans.

(*c*) The amount of the charge for United Kingdom income tax and other United Kingdom taxation on profits, including, where practicable, as United Kingdom income tax any taxation imposed elsewhere to the extent of the relief, if any, from United Kingdom income tax and distinguishing where practicable between income tax and other taxation.

(*d*) The amounts respectively provided for redemption of share capital and for redemption of loans.

(*e*) The amount, if material, set aside or proposed to be set aside to, or withdrawn from, reserves.

(*f*) Subject to sub-paragraph (2) of this paragraph, the amount, if material, set aside to provisions other than provisions for depreciation, renewals or diminution in value of assets or, as the case may be, the amount, if material, withdrawn from such provisions and not applied for the purposes thereof.

(*g*) The amount of income from investments, distinguishing between trade investments and other investments.

(*h*) The aggregate amount of the dividends paid and proposed.

(2) The Board of Trade may direct that a company shall not be obliged to show an amount set aside to provisions in accordance with sub-paragraph (1) (*f*) of this paragraph, if the Board is satisfied that that is not required in the public interest and would prejudice the company, but subject to the condition that any heading stating an amount arrived at after taking into account the amount set aside as aforesaid shall be so framed or marked as to indicate that fact. (Para. 12, Part I, 8th Sch.)

Profit and Loss Account Notes

(1) The matters referred to in the following sub-paragraphs shall be stated by way of note, if not otherwise shown.

(2) If depreciation or replacement of fixed assets is provided for by some method other than a depreciation charge or provision for renewals, or is not provided for, the method by which it is provided for or the fact that it is not provided for, as the case may be.

(3) The basis on which the charge for United Kingdom income tax is computed.

(4) Whether or not the amount stated for dividends paid and proposed is for dividends subject to deduction of income tax.

(5) Except in the case of the first Profit and Loss Account laid before the company after the coming into force of this Act,[1] the corresponding amounts for the immediately preceding financial year for all items shown in the Profit and Loss Account.

(6) Any material respects in which any items shown in the Profit and Loss Account are affected—

(*a*) By transactions of a sort not usually undertaken by the company or otherwise by circumstances of an exceptional or non-recurrent nature; or

(*b*) By any change in the basis of accounting. (Para. 14, Part I, 8th Sch.)

Auditors' Remuneration

Where the remuneration is not fixed by the company in general meeting, the amount shall be shown under a separate heading in the company's Profit and Loss Account.

For the purposes of this subsection, any sums paid by the company in

[1] 1st July, 1948.

respect of the auditors' expenses shall be deemed to be included in the expression "remuneration." (Para. 13, Part I, 8th Sch.)

Exceptions for Certain Classes of Company

Such banking and discount companies as the Board of Trade may designate are exempted from complying with certain of the foregoing requirements, but where in the Balance Sheet of such a company capital reserves, revenue reserves or provisions (other than provisions for depreciation, renewals or diminution in the value of assets) are not stated separately, any heading stating an amount arrived at after taking into account such a reserve or provision shall be so framed or marked as to indicate that fact. (Para. 23, Part III, 8th Sch.)

Assurance companies are also exempted from compliance with certain of the foregoing requirements. (*Vide* Para. 24, Part III, 8th Sch.)

Loans to Directors and Officers of the Company

(A) Prohibition of loans to directors—

(1) It shall not be lawful for a company to make a loan to any person who is its director or a director of its holding company, or to enter into any guarantee or provide any security in connection with a loan made to such a person as aforesaid by any other person:

Provided that nothing in this section shall apply either—

(*a*) To anything done by a company which is for the time being an exempt private company; or

(*b*) To anything done by a subsidiary, where the director is its holding company; or

(*c*) Subject to the next following subsection, to anything done to provide any such person as aforesaid with funds to meet expenditure incurred or to be incurred by him for the purposes of the company or for the purpose of enabling him properly to perform his duties as an officer of the company; or

(*d*) In the case of a company whose ordinary business includes the lending of moneys or the giving of guarantees in connection with loans made by other persons, to anything done by the company in the ordinary course of that business.

(2) Proviso (*c*) to the foregoing subsection shall not authorize the making of any loan, or the entering into any guarantee, or the provision of any security, except either—

(*a*) With the prior approval of the company given at a general meeting at which the purposes of the expenditure and the amount of the loan or the extent of the guarantee or security, as the case may be, are disclosed; or

(*b*) On condition that, if the approval of the company is not given as aforesaid at or before the next following annual general meeting, the loan shall be repaid or the liability under the guarantee or security shall be discharged, as the case may be, within six months from the conclusion of that meeting.

(3) Where the approval of the company is not given as required by any such condition, the directors authorizing the making of the loan, or the entering into the guarantee, or the provision of the security, shall be jointly and severally liable to indemnify the company against any loss arising therefrom. (Sect. 190.)

(B) Disclosure in accounts—

(1) The accounts which, in pursuance of this Act, are to be laid before every company in general meeting shall, subject to the provisions of this section, contain particulars showing—

(*a*) The amount of any loans made during the company's financial year to—

(i) Any officer of the company; or

(ii) Any person who, after the making of the loan, became during that year an officer of the company;

by the company or a subsidiary thereof or by any other person under a guarantee from or on a security provided by the company or a subsidiary thereof (including any such loans which were repaid during that year); and

(*b*) The amount of any loans made in manner aforesaid to any such officer or person as aforesaid at any time before the company's financial year and outstanding at the expiration thereof.

(2) The foregoing subsection shall not require the inclusion in accounts of particulars of—

(*a*) A loan made in the ordinary course of its business by the company or a subsidiary thereof, where the ordinary business of the company or, as the case may be, the subsidiary, includes the lending of money; or

(*b*) A loan made by the company or a subsidiary thereof to an employee of the company or subsidiary, as the case may be, if the loan does not exceed two thousand pounds and is certified by the directors of the company or subsidiary, as the case may be, to have been made in accordance with any practice adopted or about to be adopted by the company or subsidiary with respect to loans to its employees;

not being, in either case, a loan made by the company under a guarantee from or on a security provided by a subsidiary thereof or a loan made by a subsidiary of the company under a guarantee from or on a security provided by the company or any other subsidiary thereof.

(3) If in the case of any such accounts as aforesaid the requirements of this section are not complied with, it shall be the duty of the auditors of the company by whom the accounts are examined to include in their report on the Balance Sheet of the company, so far as they are reasonably able to do so, a statement giving the required particulars.

(4) References in this section to a subsidiary shall be taken as referring a subsidiary at the end of the company's financial year whether or not a subsidiary at the date of the loan). (Sect. 197.)

Payments to Directors and Officers of the Company.

Sect. 128 of the 1929 Act has been repealed in so far as it relates to Directors' Remuneration and new obligations have been laid down in the 1948 Act for the disclosure in the accounts of the aggregate amount of Directors' emoluments, including those of the managing director and all directors' salaried remuneration and other benefits, including past and present directors' pensions and compensation for loss of office. Moreover, the 1948 Act prohibits the making of "tax free" payments to Directors, except for those arising under a contract in force on 18th July, 1945. There are also exceptions for remuneration due or in respect of a period before the Act comes into force. The relevant sections of the 1948 Act are—

(A) Prohibition of tax free payments (Sect. 189)—

(1) It shall not be lawful for a company to pay a director remuneration (whether as director or otherwise) free of income tax or of income tax other than sur-tax, or otherwise calculated by reference to or varying with the amount of his income tax or his income tax other than sur-tax, or to or with the rate or standard rate of income tax, except under a contract which was in force on the eighteenth day of July, nineteen hundred and forty-five, and

provides expressly, and not by reference to the Articles, for payment of remuneration as aforesaid.

(2) Any provision contained in a company's Articles, or in any contract other than such a contract as aforesaid, or in any resolution of a company or a company's directors, for payment to a director of remuneration as aforesaid shall have effect as if it provided for payment, as a gross sum subject to income tax and sur-tax, of the net sum for which it actually provides.

(3) This section shall not apply to remuneration due before the commencement of this Act or in respect of a period before the commencement of this Act.[1] (Sect. 189.)

(B) Payments for loss of office or on retirement (Sect. 191)—

It shall not be lawful for a company to make to any director of the company any payment by way of compensation for loss of office, or as consideration for or in connection with his retirement from office, without particulars with respect to the proposed payment (including the amount thereof) being disclosed to the members of the company and the proposal being approved by the company.

The next two sections (192 and 193) deal with payments involving the transfer of a company's property to a director for loss of office, etc., the approval of the company being again necessary.

(C) Particulars in accounts of directors' salaries, etc. (Sect. 196)—

(1) In any accounts of a company laid before it in general meeting, or in a statement annexed thereto, there shall, subject to and in accordance with the provisions of this section, be shown so far as the information is contained in the company's books and papers or the company has the right to obtain it from the persons concerned—

(*a*) The aggregate amount of the directors' emoluments;

(*b*) The aggregate amount of directors' or past directors' pensions; and

(*c*) The aggregate amount of any compensation to directors or past directors in respect of loss of office.

(2) The amount to be shown under paragraph (*a*) of subsection (1) of this section—

(*a*) Shall include any emoluments paid to or receivable by any person in respect of his services as director of the company or in respect of his services, while director of the company, as director of any subsidiary thereof or otherwise in connection with the management of the affairs of the company or any subsidiary thereof; and

(*b*) Shall distinguish between emoluments in respect of services as director, whether of the company or its subsidiary, and other emoluments; and for the purposes of this section the expression "emoluments," in relation to a director, includes fees and percentages, any sums paid by way of expenses allowance in so far as those sums are charged to United Kingdom income tax, any contribution paid in respect of him under any pension scheme and the estimated money value of any other benefits received by him otherwise than in cash.

(3) The amount to be shown under paragraph (*b*) of the said subsection (1)—

(*a*) Shall not include any pension paid or receivable under a pension scheme if the scheme is such that the contributions thereunder are substantially adequate for the maintenance of the scheme, but save as aforesaid shall include any pension paid or receivable in respect of any such services of a director or past director of the company as are mentioned in the last foregoing subsection, whether to or by him or, on his nomination or by virtue of dependence on or other connection with him, to or by any other person; and

[1] 1st July, 1948.

(*b*) Shall distinguish between pensions in respect of services as director, whether of the company or its subsidiary, and other pensions;

and for the purposes of this section the expression "pension" includes any superannuation allowance, superannuation gratuity or similar payment, and the expression "pension scheme" means a scheme for the provision of pensions in respect of services as director or otherwise which is maintained in whole or in part by means of contributions, and the expression "contribution" in relation to a pension scheme means any payment (including an insurance premium) paid for the purposes of the scheme by or in respect of persons rendering services in respect of which pensions will or may become payable under the scheme, except that it does not include any payment in respect of two or more persons if the amount paid in respect of each of them is not ascertainable.

(4) The amount to be shown under paragraph (*c*) of the said subsection (1)—

(*a*) Shall include any sums paid to or receivable by a director or past director by way of compensation for the loss of office as director of the company or for the loss, while director of the company or on or in connection with his ceasing to be a director of the company, of any other office in connection with the management of the company's affairs or of any office as director or otherwise in connection with the management of the affairs of any subsidiary thereof; and

(*b*) Shall distinguish between compensation in respect of the office of director, whether of the company or its subsidiary, and compensation in respect of other offices;

and for the purposes of this section references to compensation for loss of office shall include sums paid as consideration for or in connection with a person's retirement from office.

(5) The amounts to be shown under each paragraph of the said subsection (1)—

(*a*) Shall include all relevant sums paid by or receivable from the company, and the company's subsidiaries, and any other person; except sums to be *accounted for to the company or any of its subsidiaries* or, by virtue of section one hundred and ninety-three of this Act, to past or present members of the company or any of its subsidiaries or any class of those members, and

(*b*) Shall distinguish, in the case of the amount to be shown under paragraph (*c*) of the said subsection (1), between the sums respectively paid by or receivable from the company, the company's subsidiaries and persons other than the company and its subsidiaries.

(6) The amounts to be shown under this section for any financial year shall be the sums receivable in respect of that year, whenever paid, or, in the case of sums not receivable in respect of a period, the sums paid during that year, so, however, that where—

(*a*) Any sums are not shown in the accounts for the relevant financial year on the ground that the person receiving them is liable to account therefor as mentioned in paragraph (*a*) of the last foregoing subsection, but the liability is thereafter wholly or partly released or is not enforced within a period of two years; or

(*b*) Any sums paid by way of expenses allowance are charged to United Kingdom income tax after the end of the relevant financial year;

those sums shall, to the extent to which the liability is released or not enforced or they are charged as aforesaid, as the case may be, be shown in the first accounts in which it is practicable to show them or in a statement annexed thereto and shall be distinguished from the amounts to be shown therein apart from this provision.

(7) Where it is necessary so to do for the purpose of making any distinction required by this section in any amount to be shown thereunder, the directors may apportion any payments between the matters in respect of which thay have been paid or are receivable in such manner as they think appropriate.

(8) If in the case of any accounts the requirements of this section are not complied with, it shall be the duty of the auditors of the company by whom the accounts are examined to include in their report thereon, so far as they are reasonably able to do so, a statement giving the required particulars.

(9) In this section any reference to a company's subsidiary—

(a) In relation to a person who is or was, while a director of the company, a director also, by virtue of the company's nomination, direct or indirect, of any other body corporate, shall, subject to the following paragraph, include that body corporate, whether or not it is or was in fact the company's subsidiary; and

(b) Shall for the purposes of subsections (2) and (3) be taken as referring to a subsidiary at the time the services were rendered, and for the purposes of subsection (4) be taken as referring to a subsidiary immediately before the loss of office as director of the company.

As will be seen in the next chapter, neither Sect. 196 nor Sect. 197 of the Act apply for the purposes of consolidated accounts.[1] (Para. 19, Part II, 8th Sch.) It may be noted that there is still no obligation to disclose the payments to *individual* directors.

Statements or Documents Annexed to the Accounts

References in this Act to a document annexed or required to be annexed to a company's accounts or any of them shall not include the directors' report or the auditors' report:

Provided that any information which is required by this Act to be given in accounts and is thereby allowed to be given in a statement annexed may be given in the directors' report instead of the accounts and, if any such information is so given, the report shall be annexed to the accounts and this Act shall apply in relation thereto accordingly, except that the auditors shall report thereon only so far as it gives the said information. (Sect. 163.)

General Observations

(1) Minimum information is extended to the Profit and Loss Account.

(2) Accounts are to be filed with the Annual Return except in the case of an exempt private company.

(3) Alternative means are afforded in certain instances of giving information by way of note or statement or report annexed.

(4) The Board of Trade have power to modify certain of the requirements (at the company's request).

(5) The Board have power by regulation to alter the provisions dealing with accounts, but such alterations are not to make the requirements more onerous unless the draft is approved by both Houses of Parliament.

[1] But Sect. 196 *does* apply to emoluments, etc., of directors of a parent company where the option is taken under Sect. 149 (5) of showing the parent company's Profit and Loss Account framed as a consolidated Profit and Loss Account.

(6) Four types of fixed asset are excepted from the rule for disclosure of such assets at cost (or valuation) less aggregate depreciation, etc., written off, e.g.—

(*a*) assets for which the necessary figures cannot be obtained without unnecessary cost or delay (relating to the period commencing with the operation of the Act);

(*b*) assets to be replaced by the renewal method wholly or in part (means of replacement and unused provision therefor must be shown in the Balance Sheet);

(*c*) investments in subsidiaries, and investments where the market value (or directors' estimate, if no market value) is shown as the amount of the investments or by way of note; so that only Trade Investments and unquoted investments where no valuation is made by the directors come within the rule;

(*d*) goodwill, patents, and trademarks.

(7) There are extensive requirements for disclosure of amount and movement of reserves (Capital and Revenue being distinguished) and provisions. The objects are to make a clear distinction between what are virtually liabilities (or diminished assets) and undistributed profits of a revenue or capital nature. No adjustments are necessary in respect of amounts *written* off (but not excess provisions for depreciation or diminished value) before the commencement of the Act.

(8) As will be seen in the next chapter, profit or loss of a subsidiary arising before purchase by a holding company is to be regarded as Capital.

(9) Investments are to be divided into the following classes—

(*a*) In subsidiaries.
(*b*) Trade.
(*c*) Quoted (not being trade investments).
(*d*) Unquoted (not being trade investments).

Where investments are shown at a market value which is taken as being higher than the stock exchange value, the latter must be disclosed.

(10) Elaborate provisions are made for the disclosure of directors' emoluments (including "expenses"), pensions and compensation for loss of office, and in each case a distinction is made between the payments in respect of services as director and those in respect of services connected with the management of the company.

(11) Material alterations are made in respect of the auditor's qualifications, duties, powers, and position.

The following skeleton Balance Sheet and Profit and Loss Account are given as a guide to the reader.

Corresponding Figures of Previous Balance Sheet £			
	Capital, Reserves, and Surplus:		
	Share Capital		
	Authorized	£	
	Issued		£
	Capital Reserves		
	Capital Redemption Reserve Fund	£	
	Share Premium Account		
	Others		
	Revenue Reserves		
	General	£	
	Future Income Tax		
	Profit and Loss Account		
	Long-term Liabilities		
	Mortgages	£	
	Debentures		
	Secured Loans		
	Others		
	Provisions		
	Current Liabilities:		
	Aggregate Bank Loans and Overdrafts	£	
	Taxation		
	Proposed Dividends (net)		
	Others		
£			£

Corresponding Figures of Previous Balance Sheet £				
	Fixed Assets.			
	Physical Assets (detailed)		£	
	Less Accumulated Depreciation			£
	Goodwill, Patents, and Trade marks			
	Interests in Subsidiaries:			
	Shares		£	
	Amounts owing by Subsidiaries			
	Trade Investments			
	Current Assets:			
	Investments			
	Quoted	£		
	Unquoted		£	
	Loans			
	To Employees for purchase of fully paid shares in the Company			
	To Officers of the Company			
	Others			
	Preliminary, etc., Expenses:			
	Commission on			
	Shares	£		
	Debentures		£	
	Discount on ditto			
	Issue Expenses of ditto			
	Preliminary Expenses			
£				£

In addition there will be required—

(1) Any necessary notes (see Paragraph 11, Part I, 8th Sch.)
(2) Signatures of two directors, or of a sole director
(3) Auditors' Report

It is not necessary to group all assets as either Fixed or Current. When the grouping of any asset under either of these headings would prejudice the "true and fair view," such asset may be shown separately

Dr. **Profit and Loss Account** *Cr.*

for the [period] ended................

Corresponding Figures of Previous Period			Corresponding Figures of Previous Period		
£		£	£		£
	To Loss on Trading			By Profit on Trading	
	,, Provision for Depreciation, Renewals, or Diminution in value of Fixed Assets			,, Income from Investments Trade Others	
	,, Interest on Debentures and other Fixed Loans			,, Miscellaneous non-trading Profits and Income (e g Transfer Fees)	
	,, Aggregate Directors' Emoluments As Directors As Executives				
	,, Aggregate Directors' or Past Directors' Pensions As Directors Other Pensions				
	,, Aggregate Compensation for Loss of Office to Directors or Past Directors Office as Directors Other Offices				
	,, Auditors' Remuneration (when not fixed by Company in General Meeting)				
	,, Provisions (other than Depreciation, etc., above)				
	,, United Kingdom Taxation on Current Profits Income Tax Profits Tax				
	,, Balance carried down.				
£		£	£		£

Profit and Loss Appropriation Account

		£			£
	To Amounts set aside for Redemption of Share Capital Loans			By Net Profit for the [period] brought down	
	,, Amounts set aside, or so proposed, to Reserves			,, Balance brought forward from last period	
	,, Dividends paid and proposed (net)			,, Withdrawals from Reserves	
	,, Balance carried forward			,, Provisions no longer required	
£		£	£		£

(1) Any necessary notes will be added (see Para. 14, Part I, 8th Sch).

(2) When relevant, Income and Expenditure will be substituted for Profit and Loss, and Trading will be deleted.

(3) Certain items need not be included in the above account unless the amounts are material.

Many difficult problems arise in practice in the application of the Companies Act, 1948; for guidance on such matters the reader is recommended to study the booklet entitled "The Companies Act, 1947," issued by the Institute of Chartered Accountants.

SECTION (C) SHARE CAPITAL

Shares. Before a company can begin its operations it must raise the necessary capital[1] either by subscription amongst the friends of the promoters or by means of a public offer.[2] In either case, the shares may be issued at par or at a premium; moreover, they may be all of one class or of different classes; whilst the amounts of subscription may be payable in instalments, or the whole sum at once, provided that the sum payable on application amounts at least to 5 per cent of the nominal amount, e.g. if the shares are to be £1 each the minimum amount payable on application is 1s. per share.

Issue of Shares of One Class at Par, Payable in One Sum. This procedure is the simplest. The entries are—

Debit Sundry Members.	Credit Share Capital.
Debit Cash.	Credit Sundry Members.

Issue of Shares Payable in Instalments. The entries are (for each allotment class, if more than one):

(*a*) Upon receipt of money from applicants for shares—

(1) Debit Cash.	Credit Application Account.
(2) Debit Application Account.	Credit Share Capital.

(*b*) Upon shares being allotted to the applicant and cash received therefor—

(1) Debit Allotment Account.	Credit Share Capital.
(2) Debit Cash.	Credit Allotment Account.

It should be carefully observed that in (*b*) the Allotment Account should first be debited so that the cash receipt entry is the second and not the first in the set; but both (*a*) and (*b*) result in the same thing, viz. a debit of cash and a credit to Share Capital Account.

Notification of all shares allotted must be made to the Registrar of Companies within one month of allotment.

(*c*) Upon the occasion of each call and cash received therefor—

(1) Debit Call Account.	Credit Share Capital.
(2) Debit Cash.	Credit Call Account.

[1] Subject to Capital Issues Committee (Treasury) approval in certain cases.

[2] Where an allotment is made by a company issuing a prospectus stating that an application has been (or will be) made for permission for the shares or debentures offered therein to be dealt in on any Stock Exchange, the allotment is void if permission has not been applied for before the third day after the first issue of the prospectus; or if permission is refused before the expiration of three weeks from the closing of the subscription lists, or such longer period not exceeding six weeks as may within the said three weeks have been notified to the applicant by the Stock Exchange.

Where there is no application as mentioned above, or it has been refused, the company must repay moneys to the applicants forthwith, and in the meantime the application moneys must have been kept in a separate banking account. (*Vide* Sect. 51, Companies Act, 1948.)

Illustration. On 1st January, 19.., X Ltd. makes an issue of 10,000 ordinary shares of £1 each and 10,000 6 per cent preference shares of £1 each, both at par, payable as below—

	Ordinary Shares	Preference Shares
	s. d.	s. d.
On Application . .	2 6	5 0
On Allotment . .	2 6	7 6
On First Call . .	10 0	7 6
On Second Call . .	5 0	

Journalize and post, assuming that the precise numbers are applied for and all payments are made at due dates.

For the purpose of giving a clear view of the transactions the cash entries are journalized, although, in practice, these would be made in the Cash Book and posted direct to the Ledger.

JOURNAL

			£	£
	Cash . . . . *Dr.* To Application (Ordinary Shares) . Being 2s. 6d. per share application money on 10,000 ordinary shares.		1,250	1,250
	Cash . . . . *Dr.* To Application (Preference Shares) . Being 5s. per share application money on 10,000 preference shares.		2,500	2,500
	Application (Ordinary Shares) . *Dr.* To Share Capital (Ordinary) . . Being 2s. 6d. per share on 10,000 shares as per minute dated.........*vide* Minute Book, p. ..		1,250	1,250
	Application (Preference Shares) . *Dr.* To Share Capital (Preference) . . Being 5s. per share on 10,000 shares as per minute dated........*vide* Minute Book, p. ..		2,500	2,500
	Allotment (Ordinary Shares) . . *Dr.* To Share Capital (Ordinary) . . Being 2s. 6d. per share on 10,000 shares as per minute dated.........*vide* Minute Book, p. ..		1,250	1,250
	Allotment (Preference Shares) . . *Dr.* To Share Capital (Preference) . . Being 7s. 6d. per share on 10,000 shares as per minute dated.........*vide* Minute Book, p. ..		3,750	3,750

JOURNAL—(*contd.*)

	£	£
Cash . . . . *Dr.* To Allotment (Ordinary Shares) . Being 2s. 6d. per share allotment money on 10,000 ordinary shares.	1,250	1,250
Cash . . . . *Dr.* To Allotment (Preference Shares) . Being 7s. 6d. per share allotment money on 10,000 preference shares.	3,750	3,750
First Call (Ordinary Shares) . . *Dr.* To Share Capital (Ordinary) . . Being 10s. per share on 10,000 shares as per minute dated.........*vide* Minute Book, p. ..	5,000	5,000
First Call (Preference Shares) . . *Dr.* To Share Capital (Preference) . . Being 7s. 6d. per share on 10,000 shares as per minute dated.........*vide* Minute Book, p. ..	3,750	3,750
Cash . . . . *Dr.* To First Call (Ordinary Shares) . Being first call money of 10s. per share on 10,000 ordinary shares.	5,000	5,000
Cash . . . . *Dr.* To First Call (Preference Shares) . Being first call money of 7s. 6d. per share on 10,000 preference shares.	3,750	3,750
Second Call (Ordinary Shares). . *Dr.* To Share Capital (Ordinary) . . Being second call of 5s. per share on 10,000 shares as per minute dated...... *vide* Minute Book, p. ..	2,500	2,500
Cash . . . . *Dr.* To Second Call (Ordinary Shares) . Being second call money of 5s. per share on 10,000 ordinary shares.	2,500	2,500

Note. In practice cash entries will be made direct into the Cash Book.

Dr. SHARE CAPITAL (ORDINARY) *Cr.*

					£
				By Application Moneys .	1,250
				,, Allotment Moneys .	1,250
				,, First Call . . .	5,000
				,, Second Call . . .	2,500
					£10,000

Dr. **Cash (Ordinary Shares)** Cr.

	£			
To Application Moneys	1,250			
,, Allotment Moneys	1,250			
,, First Call	5,000			
,, Second Call	2,500			
	£10,000			

Dr. **Application (Ordinary Shares)** Cr.

	£		£
To Share Capital	1,250	By Cash	1,250

Dr. **Allotment (Ordinary Shares)** Cr.

	£		£
To Share Capital	1,250	By Cash	1,250

Dr. **First Call (Ordinary Shares)** Cr.

	£		£
To Share Capital	5,000	By Cash	5,000

Dr. **Second Call (Ordinary Shares)** Cr.

	£		£
To Share Capital	2,500	By Cash	2,500

Dr. **Share Capital (Preference)** Cr.

			£
		By Application Moneys	2,500
		,, Allotment Moneys	3,750
		,, First Call	3,750
			£10,000

Dr. **Cash (Preference Shares)** Cr.

	£		
To Application Moneys	2,500		
,, Allotment Moneys	3,750		
,, First Call	3,750		
	£10,000		

Dr. **Application (Preference Shares)** Cr.

	£		£
To Share Capital	2,500	By Cash	2,500

Dr. **Allotment (Preference Shares)** Cr.

		£			£
To Share Capital . .		3,750	By Cash		3,750

Dr. **First Call (Preference Shares)** Cr.

		£			£
To Share Capital . .		3,750	By Cash		3,750

Note. The Cash Accounts have been shown separately, although in practice one combined account would normally be employed.

It is, however, more usual to combine the Application and Allotment Accounts, in which case the Journal entries will appear (illustrating merely the ordinary shares)—

JOURNAL

			£	£
	Cash . . . . . . *Dr.*		1,250	
	To Application and Allotment (Ordinary Shares)			1,250
	Being 2s. 6d. per share application money on 10,000 ordinary shares.			
	Application and Allotment (Ordinary Shares) . . . . . . *Dr.*		2,500	
	To Share Capital (Ordinary) . .			2,500
	Being 5s. per share (2s. 6d. on application and 2s. 6d. on allotment) on 10,000 ordinary shares of £1 each allotted as per minute dated... *vide* Minute Book, p.			
	Cash . . . . *Dr.*		1,250	
	To Application and Allotment (Ordinary Shares).			1,250
	Being 2s. 6d. per share allotment money on 10,000 ordinary shares.			

In examination work it is permissible to combine in one Journal entry the above entries with other classes of shares, e.g. the first entry would be (reverting to the above illustration), ignoring narrative—

JOURNAL

			£	£
	Cash . . . . *Dr.*		3,750	
	To Application and Allotment—			
	Ordinary Shares . . .			1,250
	Preference Shares . . .			2,500

Calls. Calls are the instalments due by members of a company otherwise than by way of allotment in respect of shares allotted, and are specified in the prospectus, if any; otherwise, the directors may make the calls at discretion or according to the company's regulations. Where Table A is adopted members are entitled to 14 days' notice of the call, which must not exceed—exclusive of premium—more than one-fourth of the nominal amount of each share (e.g. 5s. on a £1 share) and the call must not be payable at less than one month from the last call.

Most companies take power to accept payment of calls before their due dates and allow interest on the sums so prepaid. Where Table A is adopted the company may pay interest at a rate not exceeding 5 per cent per annum,[1] unless the company otherwise directs by resolution at a general meeting; but so long as calls in advance are bearing interest, the holder in question is entitled to a dividend only upon the called-up portion. In other words, he does not receive both interest *and* dividend on the prepaid call.

A call in advance is a debt against the company, and the interest (if any), unlike a dividend, is a definite charge against the company's profits.

The call in advance is credited to Calls in Advance Account and upon appropriation when the call is due for payment is transferred to the Call Account.

Illustration. X, Ltd., has made an issue of 10,000 shares of £1 each, 10s. of which has been received by way of application and allotment. The first call of 5s. is made and all members pay, including several members holding 400 shares, who pay for the balance due in full. Later the final call is made and fully met.

Show Journal entries relating to the calls, ignoring narratives.

JOURNAL

			£	£
	First Call . . . . . . Dr.		2,500	
	To Share Capital . . .			2,500
	Cash . . . . Dr.		2,600	
	To First Call			2,500
	" Calls in Advance . . .			100
	Final Call . . . . . . Dr.		2,500	
	To Share Capital			2,500
	Cash . . . . Dr.		2,400	
	Calls in Advance . . . . Dr.		100	
	To Final Call			2,500

Calls in Arrear. The treatment here is to transfer the amount of the arrears to the debit of Calls in Arrear Account, or to bring

[1] Six per cent per annum under the 1929 Table A.

the balance down on the Call Account. Upon payment cash will be debited, and the Calls in Arrear Account or the Call Account credited. A failure to pay a call at due date may imperil the holding of the member where the company has power to forfeit shares. This will be dealt with on page 815 *et seq*.

Illustration. The facts are the same as in the preceding example except that members holding 400 shares fail to pay the first call, but owing to special reasons the directors permit the members to postpone payment until the final call is made. The defaulting members pay up in full on the final call.

Show Journal entries relative to the calls (ignoring narratives).

JOURNAL

			£	£
	First Call . . . . . . Dr.		2,500	
	To Share Capital			2,500
	Cash . . . . Dr.		2,400	
	Calls in Arrear . . . . Dr.		100	
	To First Call			2,500
	Final Call . . . . . . Dr.		2,500	
	To Share Capital			2,500
	Cash . . . . Dr.		2,600	
	To Final Call			2,500
	,, Calls in Arrear			100
	Alternatively—			
	Cash . . . . Dr.		2,400	
	To First Call			2,400
	[This leaves automatically a debit of £100 on First Call.]			
	Cash . . . . Dr.		2,600	
	To Final Call			2,500
	,, First Call[1]			100

If Table A is adopted the company may charge interest at a rate not exceeding 5 per cent per annum upon calls in arrear, although the practice of public companies at all events is to fix a rate (often as high as 10 per cent) in the articles.

Further, Table A provides for dividends only upon the amounts PAID up on shares, although, again, articles may provide for some other mode, e.g. upon the nominal amount.

Interest on Calls in Advance and in Arrear. The book-keeping entries are—

(*a*) Calls in advance—

(1)	Debit Interest on Calls in Advance Credit Sundry Members	for Interest.
(2)	Debit Sundry Members Credit Cash Credit Income Tax Account[2]	for payment of Interest.
(3)	Debit Profit and Loss Account Credit Interest on Calls in Advance	for transfer of Interest charged to Profit and Loss Account

[1] This clears the balance on First Call Account.

[2] This sum will be accounted for to the Inland Revenue Authorities. [See Chapter XXI.]

(*b*) Calls in arrear—

The entries are converse to the above, the name of the Interest Account being Interest on Calls in Arrear Account.

The company may deem it a matter of prudence to carry forward the interest on calls in arrear instead of crediting it to Profit and Loss Account except to the extent of cash actually received for interest; but the *charge* for interest on calls in advance must be transferred to the debit of Profit and Loss Account. A company may, unless its Articles state otherwise, set off interest on calls in arrear against a dividend payable to the member whose calls are in arrear.

Illustration. Holders of 400 shares pay their call of 5s. in advance. The due date of the call is 1st July, the date of payment in advance being 1st June. The interest allowed is 6 per cent per annum. Show Ledger Accounts.

Dr. SUNDRY MEMBERS *Cr.*

			£	s.	d.				£	s.	d.
19.. July 1	To Cash . . .			5	6	19.. July 1	By Interest on Calls in Advance Account[1] [Interest on £100 for one month at 6 per cent per annum.]			10	0
	,, Income Tax [9s. in £] .			4	6						
				10	0					10	0

Converse entries will be made for interest on calls in arrear if the payments therefor be received by the company in the usual way. If, however, a member holding 200 shares (400 being in arrear) pays his interest, the Ledger would be—

Dr. SUNDRY MEMBERS *Cr.*

			£	s.	d.				£	s.	d.
19.. July 1	To Interest on Calls in Arrear . .			10	0	19.. July 1	By Cash . . .			2	9
							,, Income Tax . [9s. in £]			2	3
							,, Balance . .	c/d		5	0
				10	0					10	0
July 2	To Balance . .	b/d		5	0						

Dr. INTEREST ON CALLS IN ARREAR *Cr.*

			£	s.	d.				£	s.	d.
19.. ?	To Profit and Loss Account .			5	0	19.. July 1	By Sundry Members .			10	0
?	,, Balance[2] .	c/d		5	0						
				10	0					10	0
						19.. ?	By Balance . .	b/d		5	0

[1] Transferred to the debit of Profit and Loss Account.

[2] That is, 5s. only is credited to Profit and Loss Account, the balance being brought down. This has the effect of creating a full provision in respect of the debt due by members.

The Balance Sheet of a company usually shows the calls in arrear —a debit balance—as a *deduction* from the issued share capital, whilst the calls in advance, a credit balance, is added thereto, but as a separate item, the former appearing before the latter.

Interest outstanding on the above accounts is shown separately, respectively in assets and liabilities; a provision may be created in respect of the former.

The following shows the presentation indicated—

LIABILITIES SIDE OF BALANCE SHEET

	£		£
Authorized Capital (details) . . .			
Issued Share Capital—			
5,000 Shares of £1 each, 15s. called. .	3,750		
Less Calls in Arrear	250		
		3,500	
Add Calls in Advance . . .		350	
			3,850
Interest on Calls in Advance (in Creditors) .			10

ASSETS SIDE OF BALANCE SHEET

	£	£
Interest on Calls in Arrear (in Debtors) . . .	7	
Less Provision	3	
		4

Over-subscription. It very rarely happens, in practice, that the *exact* amount required by the company is applied for. If *less*, the entries will be made on the basis of the number of shares applied for if the company goes to allotment; if *greater*, some applications may be totally rejected and the application money returned; others may receive a smaller allotment than that applied for, and the excess application money returned or held on account of amounts due on allotment and calls.

It will be necessary to prepare application and allotment lists and this usually entails a considerable amount of detail work. The book-keeping entries are (other than the normal entries)—

1. Debit Application and Allotment Account, credit cash (in respect of amounts returned).

2. Debit Application and Allotment Account, credit Calls Account (in respect of amounts held on account of calls).

Illustration. The following list shows the details of application moneys, allotments, and cash retained and returned in an over-subscribed issue of shares.

Issue of 1,000 Shares of £1 each

Applicant	Shares Applied for	Shares Allotted	Amounts Paid on Application (5s.) £	Amount Due on Application and Allotment (15s.) £	Balance Due £	Amounts Transferred to Calls in Advance Account £	Amounts Returned £
A	300	100	75	75			
B	200	120	50	90	40		
C	1,820	400	455	300		100	55
D	800	300	200	225	25		
E	200	30	50	22½		7½	20
F	100	Nil	25				25
G	160	50	40	37½		2½	
	3,580	1,000	£895 (*a*)	£750 (*b*)	£65 (*c*)	£110 (*d*)	£100 (*e*)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)

Note. Column 3 = 5s. in £ being application money, i.e. ¼ of column 1.
Column 4 = 15s. in £ being application and allotment money, i.e. ¾ of column 2.
Columns 4 + 6 + 7 = columns 3 + 5.

Show entries in Ledger form.

Dr. Application and Allotment *Cr.*

		£			£
To Share Capital	(*b*)	750	By Cash (Application)	(*a*)	895
,, Calls in Advance	(*d*)	110	,, ,, (Allotment)	(*c*)	65
,, Cash returned	(*e*)	100			
		£960			£960

Dr. Calls in Advance *Cr*

		£			£
			By Application and Allotment Account	(*d*)	110

Dr. Cash *Cr.*

		£			£
To Application and Allotment Account—			By Application and Allotment Account	(*e*)	100
(Applications)	(*a*)	895	,, Balance	c/d	860
(Balances on Allotment)	(*c*)	65			
		£960			£960
To Balance	b/d	860			

Dr. Share Capital *Cr.*

		£			£
			By Application and Allotment Account	(*b*)	750

Upon the making of future calls, the proportion of calls in advance absorbed by the calls made will be debited to Calls in Advance Account and credited to Call Account.

Illustration. Assuming for simplicity that the balance of 5s. per share is called up in one sum there will be received £140, which with the transfer from Calls in Advance Account will make up the requisite credit to Call Account of 1,000 shares at 5s. In summary form the entries are:

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			£	£
	Cash . . . . . *Dr.*		140	
	Calls in Advance . . . *Dr.*		110	
	To Call			250

The amounts receivable are—

Applicant	Shares Allotted	Call—5s. £	Amount Brought Forward (Calls in Advance) £	Balance Due £
A	100	25		25
B	120	30		30
C	400	100	100	Nil
D	300	75		75
E	30	7½	7½	Nil
F	Nil			Nil
G	50	12½	2½	10
	1,000	£250	£110	£140

If separate Application and Allotment Accounts were used, they would be as follows—

Dr. APPLICATION *Cr.*

			£				£
	To Share Capital . .		250		By Cash		895
	,, *Allotment Account* . .		435				
	,, Calls in Advance . .		110				
	,, Cash returned . .		100				
			£895				£895

Dr. ALLOTMENT *Cr.*

			£				£
	To Share Capital . .		500		*By Application Account* .		435
					,, Cash		65
			£500				£500

It will be observed that the combination of the two accounts gives the same result as is shown by the Application and Allotment Account, the italicized items cancelling themselves out.

The amount of £435 is arrived at by taking the cash received £895 less transferable to calls and cash returnable £210, leaving £685 net as against application money allocable against the amount due in respect of shares allotted, £250.

The components of the item of £435 are:

Applicant	Effective Applications	Paid	"Over" (i.e. transferable to Allotment Account)	Transferred to Calls or Repayable (per previous List—Columns 6 and 7)
	£	£	£	£
A	100 at 5s. 25	75	50	
B	120 at 5s. 30	50	20	
C	400 at 5s. 100	455	200	155
D	300 at 5s. 75	200	125	
E	30 at 5s. 7½	50	15	27½
F	*nil* *nil*	25		25
G	50 at 5s. 12½	40	25	2½
	£250	£895	£435	£210
	(1)	(2)	(3)	(4)

Note. Columns 1 + 3 + 4 = 2.

Issue of Shares at a Premium. A company may, owing to the attractiveness of its shares, be able to make an issue of shares at a premium by which it will receive an amount per share exceeding the nominal amount or the paid up amount, e.g. a £1 share, fully paid, issued at 22s. 6d.; or a 2s. share, fully paid, at 2s. 3d.; or a £1 share, 10s. paid, at 11s. 3d. The premiums are 2s. 6d., 3d., and 1s. 3d. respectively.

Many successful companies are, by reason of continuous development and expansion, constantly requiring further capital, which they raise by an issue of shares to the public, or by offering to the members the right to take up a certain number at a stipulated price which usually is lower than the quoted market price. The member thus obtains a valuable saleable right.

The premium receivable is credited to a separate account called Share Premium Account, the class of share (where necessary) being described. The amount must be regarded as capital, but it may be used wholly or in part towards paying the premium on the redemption of redeemable preference shares, writing off preliminary expenses, commissions and discounts on issue of shares or debentures.

Illustration. X, Ltd., issues 10,000 shares of £1 at 23s. payable 5s. on application, 8s. on allotment (including the premium of 3s.),

10s. call. All the shares are subscribed, allotted, and paid for at due dates. Show Journal entries, opening a combined Application and Allotment Account, entering the cash entries in the Cash Book and posting to Ledger.

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			£	£
	Application and Allotment . . *Dr.* To Share Capital . . . . ,, Share Premium . . . . Being 5s. per share on application and 8s. per share on allotment inclusive of premium of 3s. on 10,000 shares of £1 allotted as per directors' resolution dated........*vide* Minute Book, p. ...		6,500	 5,000 1,500
	Call . . . . *Dr.* To Share Capital . . . . Being 10s. per share on 10,000 shares of £1 each for the first and final call made in accordance with terms of issue as per directors' resolution dated........*vide* Minute Book, p. ...		5,000	 5,000

The following is the Cash Account, which, as already stated, may be journalized in examination work, where the posting to the Ledger is not called for—

Dr. CASH *Cr.*

		£				
	To Application and Allotment Account— Sundry Applicants, Receipt of Application Moneys, 5s. per Share on 10,000 Shares of £1 each . . .	2,500				
	Receipt of Allotment Moneys, 8s. per Share on 10,000 Shares of £1 each, viz. 5s. Allotment, 3s. Premium .	4,000				
	,, Call Account— Receipt of Call Moneys, 10s. per Share on 10,000 Shares of £1 each . . .	5,000				

Dr. SHARE CAPITAL *Cr.*

						£
				By Application and Allotment Account . . .	J.	5,000
				,, Call Account . . .	J.	5,000

Dr. SHARE PREMIUM *Cr.*

						£
				By Application and Allotment Account . . .	J.	1,500

Dr.			APPLICATION AND ALLOTMENT		Cr.
		£			£
To Share Capital . .	J.	5,000	By Cash: Application Moneys	C.B.	2,500
,, Share Premium . .	J.	1,500	,, ,, Allotment Moneys (including Premium) .	C.B.	4,000
		£6,500			£6,500

Dr.			CALL		Cr.
		£			£
To Share Capital .	J.	5,000	By Cash	C.B.	5,000

Note. J signifies posting from Journal.

It is clear that without further transactions, the Balance Sheet will be—

BALANCE SHEET

	£		£
Authorized Capital . .	?	Cash	11,500
Issued Share Capital: 10,000 Shares of £1 each fully paid . . .	10,000		
Share Premium Account .	1,500		
	£11,500		£11,500

Issue of Shares at a Discount. Until the passing of the Companies Act, 1929, it was illegal to issue shares at a discount. The severity of this rule has been modified by permitting an issue of shares at a discount, provided that the company conforms to Sect. 57 of the Companies Act, 1948.

The material requirements of this section are—

1. The shares are of a class *already* issued.

2. More than one year has elapsed since the date on which the company was entitled to commence business.

3. The issue must be authorized by an *ordinary* resolution passed in general meeting, such resolution to specify the maximum rate of discount. (This resolution is not effective unless filed with the Registrar of Companies within 15 days.)

4. Sanction of the Court must be obtained (the issue must be made within either one month from the date of the sanction or such extended time as the Court may allow). The Court may give sanction on such terms and conditions as it thinks fit.

It is essential that every prospectus relating to the issue of shares and every subsequent Balance Sheet issued by the company shall contain particulars of such discount as has not been written off at the date of the issue of the prospectus or Balance Sheet in question.

Illustration. A company finds itself in need of further capital and the directors decide to make a further issue of £1 ordinary shares, which are at present quoted at 15s. It is decided to apply to the Court for an order under Sect. 57 sanctioning the new issue to be made at a discount of 25 per cent. The necessary formalities are carried out and 50,000 shares are issued, the whole number being applied for and allotted (5s. on application, 10s. on allotment).

Show Journal entries.

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			£	£
	Cash . . . . *Dr.* To Application and Allotment . . Being application and allotment moneys of 5s. per share on application, 10s. per share on allotment issued in accordance with ordinary resolution dated...........*vide* Minute Book, p. ..		37,500	37,500
	Application and Allotment . . *Dr.* Discount on Shares . . . . *Dr.* To Ordinary Share Capital . . . Being 50,000 ordinary shares issued at a discount of 25% in accordance with ordinary resolution dated........and sanction of the Court dated........*vide* Minute Book, p. ..		37,500 12,500	50,000

Forfeiture of Shares. As a matter of practice almost every company takes power, either by the adoption of Table A or by an express provision in its articles, to forfeit the shares of members who have failed to pay the due calls; otherwise no right of forfeiture of shares exists. Table A provides that notice must be given by the company to the defaulting member of the intention to forfeit; such notice must state the amount due, with interest, if any, and intimate that if payment is not made within 14 days (or such longer time as the directors may decide) from the date of the notice the shares will be forfeited. If the notice is not properly complied with by the member, the directors may pass a resolution of forfeiture. Under Table A, the person whose shares have been forfeited remains liable to the company for all calls owing as at the date of forfeiture until the company has received payment in full—it matters not from whom.

After forfeiture the company is entitled, subject to any contrary provision in the articles, to reissue the shares at ANY price whatsoever so long as the amount received on reissue, added to the amount received on the shares reissued from the original holder, is at least equal to the called-up value in the case of shares not fully paid or to the nominal value in the case of fully paid shares.

Upon reissue of the forfeited shares and the payment by the new holder of the unpaid balance on the shares, the original holder, notwithstanding any proviso in the company's articles, is *pro tanto*

absolved, and can never be called upon to pay more than the net balance remaining, i.e. the balance unpaid as at the date of forfeiture, less the amount paid by the new holder.

The entries in the books of account are—

1. Debit Share Capital Account with the NUMBER of shares forfeited at the CALLED-UP value.
   Credit Forfeited Shares Account.
2. Debit Forfeited Shares Account.
   Credit Call Account

in respect of the unpaid call of the defaulting member.

Two very frequent mistakes common to most students may be mentioned.

1. The debit to share capital must be proportionate to the amount in terms of money standing to the credit of this account. Many students debit the account with the number of shares forfeited at the *nominal* value, e.g. £1.

The debit must be based, as mentioned, upon the CALLED-UP value and may be alternatively stated thus: the amount to be debited to share capital is the amount produced by the number of shares forfeited, divided by the whole number of shares of that class issued, multiplied by the amount standing to the credit of share capital of that class. Expressed briefly the formula is—

$$\frac{\text{number of shares forfeited}}{\text{number of shares issued}} \times \text{credit balance of Share Capital Account.}$$

2. The balance of unpaid calls must not be transferred to the debit of share capital, but to the debit of Forfeited Shares Account.

Illustration. 10,000 shares of £1 each have been issued upon which 15s. has been called. Owing to failure to pay the call of 2s. a member's shares numbering 1,000 are forfeited.

The requisite debit to share capital is 1,000 times 15s., i.e. £750, or computed in the alternative way—

$$\frac{\text{number of shares forfeited}}{\text{number of shares issued}} \times \text{credit balance of Share Capital Account}$$

i.e. $\frac{1,000}{10,000} \times$ [1]7,500 = £750

The balance of Forfeited Shares Account may always be proved because it represents the excess of amounts called on the defaulting member over those unpaid by him, i.e. the amount actually paid, which is the member's loss and the company's gain. In the above illustration, the amount called is 15s., and the amount unpaid 2s.; hence there is a profit of 13s. per share on 1,000 shares, as shown below. (Narratives ignored.)

[1] It will be recollected that the Share Capital Account is credited on the occasion of each call and is, in the normal course of events, reflected in Cash or Debtors (Call Account).

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			£	£
	Share Capital . . . . Dr. To Forfeited Shares. . . .		750	750
	Forfeited Shares . . . . Dr. To Call		100	100

In examination work it is permissible to combine the two entries thus—

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			£	£
	Share Capital . . . . Dr. To Call . . . . . . ,, Forfeited Shares . . .		750	100 650[1]

Illustration. Prosperity, Ltd., made an issue of 50,000 ordinary shares of £1 each. The 10s. payable on application, allotment, and first call has been paid in full. A second call of 5s. a share is made, and V. Jones a holder of 100 shares fails to meet the call. After due notice the directors passed a resolution effecting the forfeiture of his shares. Show Journal entries relative to the second call and the forfeiture and Share Capital Account.

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			£	£
	Ordinary Share Capital . . . . Dr. To Forfeited Shares . . . . Being 100 ordinary shares, 15s. called up forfeited in accordance with resolution of directors dated.........*vide* Minute Book, p.		75	75
	Forfeited Shares . . . . Dr. To Second Call . . . . Being transfer of amount unpaid by Jones on second call on 100 ordinary shares forfeited as above.		25	25

Dr. ORDINARY SHARE CAPITAL *Cr.*

			No. of Shares	£				No. of Shares	£
	To Forfeited Shares Account		100	75		By Balance . .	b/d	50,000	25,000
	,, Balance . .	c/d	49,900	37,425		,, Second Call Account . .			12,500
			50,000	£37,500				50,000	£37,500
						By Balance . .	b/d	49,900	37,425

[1] I.e. 13s. on 1,000 shares = £650.

Dr. SECOND CALL **Cr.**

		£			£
To Ordinary Share Capital Account . . .		12,500	By Cash		12,475
			„ Forfeited Shares Account		25
	£	12,500		£	12,500

Dr. FORFEITED SHARES **Cr.**

		£			£
To Second Call Account .		25	By Ordinary Share Capital Account . . .		75[1]
„ Balance . . .	c/d	50			
		£75			£75
			By Balance . . .	b/d	50

Alternatively, the credit of £75 may be made to the second Call Account, leaving £50 to be transferred to Forfeited Shares Account, thus—

Dr. SECOND CALL **Cr.**

		£			£
To Ordinary Share Capital Account . . .		12,500	By Cash		12,475
„ Forfeited Shares Account		50	„ Share Capital . .		75
	£	12,550		£	12,55

The credit balance on forfeited shares is the total calls on 100 shares at 15s., less 5s. per share unpaid, leaving a profit to the company of £50, that is, the amount actually paid by Jones.

The profit on forfeiture is legally available for dividend, subject to any contrary provisions in the articles of the company, but until the shares have been reissued and fully paid no profit can arise.

The Balance Sheet, after giving effect to the above entries, will contain the following items on the liabilities side—

	£
Issued Share Capital—	
49,900 Ordinary Shares of £1 each, 15s. paid	37,425
Forfeited Shares	50

This will equal the bank balance of £37,475 shown as an asset in the ordinary way.

Reissue of Forfeited Shares. It has been seen that the company may *reissue* shares at a discount provided that it receives (in all) at least the amount per share with which the member is credited after the reissue, e.g. if a share is credited with 15s. at least this sum must have been received by the company in respect of such

[1] I.e. 100 at the called-up value of 15s, or $\frac{100}{50,000} \times$ £37,500 = £75.

share; if it is a £1 share credited as fully paid the sum received must be at least £1.

Entries on reissue are—

(i) Debit Sundry Members } for the amount payable by
Credit Share Capital } new member.
(ii) Debit Forfeited Shares } for discount on reissue.
Credit Share Capital }
(iii) Debit Cash } for receipt of amount payable by
Credit Sundry Members } new member.

Or more shortly—

(i) Debit Sundry Members.
Forfeited Shares.
Credit Share Capital.
(ii) Debit Cash.
Credit Sundry Members.

Illustration. X, Ltd., has received from a member, on 100 shares of £1 each the sum of 15s., but the subsequent call of 2s. 6d. thereon being unpaid the shares are forfeited. As there is a profit of 15s. on each share, the company may pass on this gain to the person who takes up the reissued shares, and if they are to be credited as fully paid the applicant must pay on each share at least 5s., so that in all the company has received £1 on each share credited as fully paid. If the company's price for reissue of the shares as fully paid is 8s., it has still a profit of 3s. for it has received 15s. plus 8s. for a £1 share; in other words, the discount on reissue is 12s., i.e. £1 less 8s., but the previous profit was 15s., still leaving a gain of 3s. for the company.

If the company reissues the shares at a premium, this is in the nature of further profit.

Some accountants prefer to open a new account called Forfeited Shares Reissued Account, in which case the entries are—

(i) Debit Forfeited Shares Reissued Credit Share Capital	for the number of shares at the price at which the shares are to be credited.
(ii) Debit Sundry Members	for amount due payable by new members.
Forfeited Shares	for discount on reissue.
Credit Forfeited Shares Reissued	for the number of shares at the price at which the shares are to be credited.
(iii) Debit Cash Credit Sundry Members	for amount paid by new members.

If the shares are reissued at a premium the amount thereof will be credited to Share Premium Account or Premium on Shares Reissued Account.

Illustration. Assume that in the illustration on page 818 100 shares are reissued to G. Smith at 14s. a share to be credited as fully paid, the Ledger entries (entering only the last set of entries) are—

Dr. ORDINARY SHARE CAPITAL **Cr.**

							No. of Shares	£
					By *Balance* . .	*b/d*	*49,900*	*37,425*

Dr. ORDINARY SHARE CAPITAL[1] **Cr.**

							No. of Shares	£
					By Forfeited Shares Reissued Account		100	100

Dr. FORFEITED SHARES REISSUED **Cr**

			£				£
	To Ordinary Share Capital Account . . .		100		By Smith[2]		70
					,, Forfeited Shares Account[2]		30
			£100				£100

Dr. FORFEITED SHARES **Cr.**

			£				£
	To Forfeited Shares Reissued Account . . .		30		By *Balance* . . .	*b/d*	*50*
	,, Balance . . (*a*)	c/d	20				
			£50				£50
					By Balance . .	b/d	20

(*a*) Unless there are other shares which may be reissued, the balance of this account may be transferred to a Share Premium Account or used to write off Preliminary Expenses; or even to Profit and Loss Account, although the latter procedure violates the principles of sound financial policy. It must be observed that the second or final call will be on 49,900 and not 50,000 shares, and when disposed of, the two Share Capital Accounts may be merged.

Dr. G. SMITH **Cr.**

			£				£
	To Forfeited Shares Account		70		By Cash		70

[1] Until the other shares are fully paid it is preferable to open a separate account of those reissued as fully paid.

[2] Shown separately for clarity.

Dr. CASH Cr.

		£			
To *Balance* . . .	*b/d*	*37,475*			
" Smith . . .		70			

Note. Items in italics are the balances as shown on pages 817 and 818.

The final profit on the 100 shares is proved by taking the total cash received in respect of the 100 shares, and deducting from it the amount at which the shares are credited, viz. cash received 10s. (from first holder) plus 14s. (from the second holder), in all 24s. a share credited as fully paid; hence, a profit on 100 shares at 4s. per share, viz. £20.

Treatment of Balance of Forfeited Shares Account. It will be clear that until the shares are fully paid the credit balance on forfeited shares cannot be considered as a final profit, because the company may, on reissue, allow a discount to the purchaser of the shares forfeited to the full extent of the amount in credit therefor in Forfeited Shares Account. Thus, if there were 100 shares previously forfeited upon which there was a credit balance on Forfeited Shares Account of 8s. per share the company might reissue them as fully paid for 12s. per share. When, therefore, part of the shares forfeited are reissued, only such portion of the amount in credit in Forfeited Shares Account may be taken as final profit representing profit on the shares reissued as fully paid. Thus, if of the foregoing 100 shares upon which there is a credit on forfeited shares of £40 (8s. a share) sixty are reissued for 15s. per share to be credited as fully paid, the final profit will be 60 × (8s. + 15s. – 20s.) 3s. = £9. The company has finally credited share capital with £60, but it has received in all 23s. per share, against which 20s. per share stands to the credit of share capital. The balance of Forfeited Shares Account will be brought down, pending the result of the further reissue in respect of the forty shares.

The Ledger entries would be—

Dr. FORFEITED SHARES Cr

		£			£
To Loss on Reissue of Shares Credited as fully paid [60 at 5s.] . .		15	By Balance . . .	b/d	40
" Profit on Shares Reissued Account . . .		9			
" Balance . . .	c/d	16			
		£40			£40
			By Balance[1] . . .	b/d	16

Dr. CASH Cr.

		£			
To Share Capital Account [60 at 15s.] . . .		45			

[1] The balance represents amounts paid in respect of 40 shares forfeited and not yet reissued, i.e. 40 at 8s.

Dr. **PROFIT ON SHARES REISSUED** Cr.

				By Forfeited Shares Account[1]			£ 9

Dr. **SHARE CAPITAL** Cr.

				By Cash			£ 45
				,, Forfeited Shares Account			15
							60

The Forfeited Shares Account can be the more readily understood by splitting the account as follows—

Dr. **FORFEITED SHARES** Cr.

		40 Shares	60 Shares			40 Shares	60 Shares
		£	£			£	£
To Loss, etc.			15	By Balance	b/d	16	24
,, Profit, etc.			9				
,, Balance	c/d	16					
		£16	£24			£16	£24
				By Balance	b/d	16	

Reissue of Forfeited Shares Previously Issued at a Premium and Forfeited. Where shares have been issued at a premium, it has already been seen that the premium must be credited to Share Premium Account which can only be reduced in the special ways permitted by Sect. 56, Companies Act, 1948. If, therefore, shares are forfeited in respect of which a premium has already been received, the premium cannot be transferred to the credit of Forfeited Shares Account. The Share Premium Account will accordingly be no longer proportionate to the balance on Share Capital Account.

Illustration. A, Ltd., whose authorized share capital is £10,000 in £1 shares, issued the whole of its capital to the public at a premium of 2s. per share, payable as follows: On application and allotment 12s. per share (including premium), first call of 2s. per share.

The application and allotment moneys were received in full, but members holding 1,000 shares failed to pay the call of 2s., and in consequence the shares were forfeited. At a later date and before further calls were made, 500 of these shares were reissued as fully paid for a consideration of 16s. per share. Write up Ledger Accounts.

[1] The balance represents the sum of the payments on 60 shares (1) by the original allottee of 8s., and (2) by the subsequent holder of 15s., amounting to 23s. less the amount credited in respect thereof, i.e. 20s. This gives a profit of 3s. on 60 shares.

Dr. **Share Capital** *Cr.*

		Shares	£			Shares	£
To Forfeited Shares Account .		1,000	600	By Application and Allotment Account . .		10,000	5,000
,, Balance . .	c/d	9,000	5,400	,, First Call Account			1,000
		10,000	£6,000			10,000	£6,000
				By Balance . .	b/d	9,000	5,400

Dr. **Share Capital (Fully Paid)** *Cr.*

		Shares	£			Shares	£
To Balance . .	c/d	500	500	By Cash . . .		500	400
				,, Forfeited Shares Account . .			100
		500	£500			500	£500
				By Balance . .	b/d	500	500

As soon as the amount owing on the balance of 9,000 shares has been fully paid, the two accounts will be merged and made into one account.

Dr. **Share Premium** *Cr.*

		Shares	£			Shares	£
				By Cash . .		10,000	1,000[1]

Dr. **First Call** *Cr.*

		Shares	£			Shares	£
To Share Capital Account .		10,000	1,000	By Cash . . .		9,000	900
				,, Forfeited Shares Account . .		1,000	100
		10,000	£1,000			10,000	£1,000

[1] The premium received on the subsequently forfeited shares must remain in this account, 10s. per share being transferred from Share Capital Account to Forfeited Shares Account.

Dr. **Forfeited Shares** *Cr.*

			£				£
	To First Call Account		100		By Share Capital Account		600
	,, Balance	c/d	500				
			£600				£600
	To Share Capital Account		100		By Balance	b/d	500
	,, Profit on Shares Reissued Account		150				
	,, Balance	c/d	250				
			£500				£500
					By Balance	b/d	25

Dr. **Profit on Shares Reissued** *Cr.*

							£
					By Forfeited Shares Account		150

Notes. (1) The accuracy of the book-keeping in respect of the 500 shares reissued may be verified as follows—

	£
Cash received from original allottee (excluding premium), 500 at 10s.	250
Cash received from new holder, 500 at 16s.	400
Total cash received	£650

Since the Share Capital Account is credited with £500, there is a profit on the reissue of £150. The profit is thus 500 × 6s.

(2) The balance on Forfeited Shares Account represents the temporary profit on the shares forfeited and not yet reissued, i.e. 500 shares at 10s = £250. The balance of the account shows the maximum amount the company may lose on the reissued shares to keep within the law [i.e. 500 at 10s = £250]. If therefore the company reissues the 500 shares as fully paid for 10s it will have received in all 22s., viz. 10s. plus 2s. premium from original allottee and 10s. from the new holder.

(3) The student must bear in mind that the Share Capital Account will be debited and Forfeited Shares Account credited with the full amount called up, and not the amount which has been paid up on the shares to the date of the forfeiture.

Reissue of Forfeited Shares Issued at a Discount. Where shares issued at a discount are forfeited, a proportionate part of the discount should be written off to Forfeited Shares Account. On reissue, discount proportionate to the shares reissued may be restated in the books, so that the discount on shares will always

remain in proportion to the shares actually issued. This treatment differs from that in respect of premiums, outlined in the preceding paragraph.

The Discount on Shares Account will be opened *on allotment* when the company becomes liable to allow the discount.

Illustration. A, Ltd., makes an issue of 10,000 £1 ordinary shares at a discount of 2s. per share, payable as follows—

On Application and Allotment . . .	8s.
On First Call	5s.
On Second Call	5s.

Members holding 400 shares do not pay the second call and the shares are duly forfeited, 200 of which are reissued as fully paid at 10s. per share.

Show Ledger Accounts.

Dr. ORDINARY SHARE CAPITAL *Cr.*

		£			£
To Forfeited Shares Account		400	By Application and Allotment Account . .		4,000
,, Balance . . .	c/d	9,800	,, Discount on Shares Account . . .		1,000
			,, First Call Account .		2,500
			,, Second Call Account .		2,500
			,, Forfeited Shares Account		200
	£	10,200		£	10,200
			By Balance . . .	b/d	9,800

Dr. DISCOUNT ON SHARES *Cr.*

		£			£
To Ordinary Share Capital Account . . .		1,000	By Forfeited Shares Account		40
,, Forfeited Shares Account		20	,, Balance . . .	c/d	980
		£1,020			£1,020
To Balance . . .	b/d	980			

Dr. SECOND CALL *Cr.*

		£			£
To Share Capital Account .		2,500	By Cash		2,400
			,, Forfeited Shares Account		100
		£2,500			£2,500

Dr. FORFEITED SHARES *Cr.*

		£			£
To Discount on Shares Account . . .		40	By Share Capital Account .		400
,, Second Call Account .		100	,, Cash		100
,, Share Capital Account .		200	,, Discount on Shares Account . . .		20
,, Profit on Shares Reissued Account[1] . . .		50			
,, Balance[2] . . .	c/d	130			
		£520			£520
			By Balance . . .	b/d	130

Surrender of Shares. Without the sanction of Court, shares can only be surrendered as a short cut to forfeiture, and, generally speaking, surrender takes place where the purchase consideration satisfied in shares has turned out to be excessive.

Illustration. Spes, Ltd., purchased from Trader his business as a going concern, the consideration being the allotment to him of 10,000 shares of £1 each, credited as fully paid. Owing to over-valuation of certain assets at the date of sale it was agreed that Trader should surrender 2,000 of his shares. The Court sanctioned the agreement.

Show Journal entries in the books of the company.

JOURNAL

			£	£
	Share Capital . . . . . *Dr.*		2,000	
	To Assets (as specified)			2,000
	Being the surrender of 2,000 shares of £1 each fully paid in respect of adjustment of purchase consideration by reason of over-valuation of assets as per agreement dated.......per directors' resolution and sanctioned by the Court *vide* Minute Book, p.			

The issued share capital, obviously, is now £8,000.

General Illustration. Anti-Grab, Ltd., make an issue of 10,000 shares of £1 each at 22s. 6d. per share, as follows—

[1] This is a final profit on 200 shares as the combined net sum received is 23s. [i.e. 13s. and 10s.] to which must be added 2s. discount (this loss being shown in Discount on Shares Account), showing 25s. as against 20s. per share credited to share capital, this giving a profit of 5s. on 200 shares = £50.
It would be advisable to write off the above-mentioned 2s. discount on the 200 shares by debiting Profit on Reissued Shares Account and crediting Discount on Shares Account.

[2] The balance represents 200 shares forfeited and not yet reissued upon which 13s. has been received per share. The account has been debited with the discount of £40 less £20 (which will be written back when the remaining shares are reissued as fully paid), so that the balance brought down is the net receipt and not the 15s. per share.
The Discount on Shares Account shows a net debit of £980, which is 2s. in £ on the issued share capital of £9,800.

	Amount	Date
	s. d.	
Payable on Application	2 6	1st August
Payable on Allotment (including Premium)	5 0	10th August
First Call	10 0	30th September
Second Call	3 0	31st October
Third Call	2 0	30th November

The application and allotment moneys are duly received and in addition holders of 5,000 shares pay in full on allotment, interest being credited to them at 6 per cent per annum.[1] Holders of 200 shares fail to pay the first call, and after due notice their shares are forfeited. The amounts payable on the second call (made after the forfeiture) are paid in full, except that a holder of 100 shares fails to pay. On the 15th November, 150 of the 200 shares forfeited are reissued, credited with 18s. paid for 13s. per share. The new holder pays for these shares in full, the balance of 2s. per share being counted as a call in advance. The final call is met in full, including the arrears of the second call, on which has been charged interest at 5 per cent per annum.

Show Journal entries including cash (ignoring narratives) assuming that cash has not been received or paid in respect of interest on calls in arrear and in advance. Income tax to be ignored.

JOURNAL

		£	s.	d.	£	s.	d.
19..							
Aug. 1	Cash . . . . . . *Dr.*	7,500	0	0			
	To Application and Allotment .				2,500	0	0
	,, Calls in Advance . . .				3,750	0	0
	,, Share Premium . . .				1,250	0	0
10	Application and Allotment . *Dr.*	2,500	0	0			
	To Share Capital . . .				2,500	0	0
Sept. 30	First Call . . . . . *Dr.*	5,000	0	0			
	To Share Capital . . .				5,000	0	0
	Calls in Advance . . . . *Dr.*	2,500	0	0			
	Calls in Arrear . . . . *Dr.*	100	0	0			
	Cash . . . . . . *Dr.*	2,400	0	0			
	To First Call				5,000	0	0
	Interest on Calls in Advance *Dr.*	31	8	9			
	(£3,750 at 6% p.a. for 51 days i.e. 10th Aug. to 30th Sept.)						
	To Sundry Members . . .				31	8	9

[1] Five per cent per annum only is allowed by Table A (1948), unless the company in general meeting directs otherwise.

JOURNAL—*contd.*

19..		£	s.	d.	£	s.	d.
Sept. 30	Share Capital . . . . *Dr*	150	0	0			
	To Calls in Arrear . . .				100	0	0
	,, Forfeited Shares . . .				50	0	0
Oct. 31	Second Call . . . . *Dr.*	1,470	0	0			
	To Share Capital . . .				1,470	0	0
	Calls in Advance . . . *Dr.*	750	0	0			
	Calls in Arrear . . . *Dr.*	15	0	0			
	Cash . . . . . *Dr.*	705	0	0			
	To Second Call				1,470	0	0
	Interest on Calls in Advance . *Dr.* (£1,250 at 6% p.a. for 31 days, i.e. 1st Oct. to 31st Oct.)	6	7	5			
	To Sundry Members . . .				6	7	5
Nov. 15	Cash . . . . *Dr.*	112	10	0			
	Forfeited Shares . . . *Dr.*	37	10	0			
	To Share Capital . . .				135	0	0
	,, Calls in Advance . . .				15	0	0
30	Final Call . . . *Dr.*	995	0	0			
	To Share Capital . .				995	0	0
	Calls in Advance . . . *Dr.*	515	0	0			
	Cash . . . . . *Dr.*	495	0	0			
	To Calls in Arrear . . .				15	0	0
	,, Final Call				995	0	0
	Interest on Calls in Advance *Dr.* (£500 at 6% p.a. for 30 days and £15 at 6% p.a. for 15 days, i.e. 1st Nov. to 30th Nov., and 15th Nov. to 30th Nov respectively.)	2	10	1			
	To Sundry Members . . .				2	10	1
	Sundry Members . . . *Dr.*		1	3			
	To Interest on Calls in Arrear . (£15 at 5% p.a. for 30 days, i.e. 1st Nov. to 30th Nov)					1	3

The Ledger Accounts will be written up in the ordinary way from the above Journal entries.

When the postings have been completed the balances will appear as follows—

TRIAL BALANCE

	Dr. £	s.	d.	Cr. £	s.	d.
Cash	11,212	10	0			
Share Capital				9,950	0	0
(a) Share Premium				1,250	0	0
(b) Forfeited Shares				12	10	0
Interest—						
Calls in Arrear					1	3
Calls in Advance	40	6	3			
Sundry Members for Interest—						
Calls in Arrear		1	3			
Calls in Advance				40	6	3
	£11,252	17	6	£11,252	17	6

Notes. (*a*) 2s. 6d. per share received in respect of 10,000 shares.

(*b*) The amount paid on 50 shares forfeited, but not reissued, i.e. 50 at 7s. 6d., less premium of 2s. 6d.

There is no final profit on the 150 shares reissued as the total amount received for shares credited as 18s. paid is 22s. 6d. (i.e. original holder 7s. 6d., new holder 15s.), but of this 2s. 6d. is in respect of premium, whilst 2s. is in respect of call in advance, thus leaving a net receipt of 18s. Alternatively, as the new holder pays 15s., of which 2s. represents a call in advance, the company by crediting share capital with 18s. as against a receipt for it of 13s. incurs a loss of 5s., which is exactly covered by the amount paid by the original allottee, excluding premium. Further, as the reissued shares are fully paid at the date of the above Trial Balance, it can be seen that the company has received in all 22s. 6d. (i.e. original holder 7s. 6d., new holder 15s.), but 2s. 6d. thereof has been credited to Premium Account, leaving the sum of £1 per share credited to Share Capital.

Balancing the Share Register. In large companies, prior to the preparation of the dividend warrants from the dividend sheets it is essential to strike a balance on the Share Register the total of which must agree with the issued capital of the company.

Usually, as a matter of practical necessity, the Register is subdivided, as with Ledgers in the sectional balancing principle, so that it is necessary to employ a Transfers Posting Journal, ruled for the number of separate Registers in use, thus—

			Transferee's Registers			Transferor's Registers		
Date	Details	Shares Transferred	1	2	3	1	2	3
		100	100					100
		400		400			400	
		50			50	50		
		200	200				200	
		750	300	400	50	50	600	100

At the date of closing the Register the totals will be incorporated into an adjustments summary, the total of the individual balances in each Register agreeing therewith.

[If not the error(s) will have to be located.]

Illustration. Assuming the transfers for the year are as above and the opening balances of the Registers are as below, show Share Adjustment Summary.

	Shares
No. 1	35,000
No. 2	47,000
No. 3	18,000
	100,000

Shares Adjustment Summary

	Registers			Totals
	1	2	3	
Balances, opening	35,000	47,000	18,000	100,000
Add Transferees	300	400	50	750
	35,300	47,400	18,050	100,750
Less Transferors	50	600	100	750
Balances, closing	35,250	46,800	17,950	100,000

Stock Units. In recent years large numbers of companies have introduced Stock units in order to save the enormous trouble involved in handling transfers of Shares because of the necessity to register their distinctive numbers.

Stock (as distinct from Shares) involves no registered numbers and therefore facilitates transfers, but is not a popular form of investment, so that the Stock unit has been devised, allowing the share equivalent to be negotiated in the ordinary way; e.g. Kotes Ltd. has shares of 10s. each fully paid, so that if it desires to take advantage of the use of stock units, it will convert its Shares into the form of Stock divided into units of 10s. each. This form satisfies both needs (*a*) to avoid dealing with distinctive numbers and (*b*) permitting transactions in "Share" form.

Illustration. X Ltd., has a share capital of 1,000,000 shares of 5s. each fully paid. This is converted into £250,000 stock divided into 1,000,000 5s. units. As far as a member of the company is concerned, he is in just the same position after the conversion as before. If he wishes to sell part of his holding, the only difference is that he sells so many stock units instead of shares of the same nominal amount.

It will, no doubt, be remembered that of necessity the Stock must be *fully paid*.

The need for this procedure is to a great extent obviated by Sect. 74 of the Companies Act, 1948, which provides that if *all* the issued shares in a company (or *all* the issued shares of any class) are *fully paid* and rank *pari passu* for all purposes, such shares need not have distinguishing numbers.

SECTION (D) DEBENTURES

Debentures. A debenture is a document acknowledging a loan to a company and is generally executed under the seal of the company. It usually (but not necessarily) provides for payment of interest at a stated rate and/or repayment of capital, and may give security for the payment over some or all of the assets and undertaking of the company (*Lemon* v. *Austin Friars Investment Trust*). A debenture may be classified thus—

1. As to **security**. Containing a charge either—

(*a*) Specific, which constitutes a mortgage to trustees with a deed of trust, in respect of specified and definite assets.

(*b*) Floating, which constitutes a charge on the undertaking as a whole (subject to any specific charge).[1]

The former precludes the company from dealing with the subject-matter comprised in the charge, but the latter does not prevent the company from changing the assets from time to time.

(*c*) Naked debenture which confers on the holder no security of any kind.

2. As to **priority**—First debenture. Second debenture.

3. As to **permanence**—Redeemable debenture. Irredeemable debenture.

Debentures may be issued at par, at a premium or at a discount; either in a series or in the form of stock.

Issue of Debentures. A company must have borrowing powers so as to give validity to debentures, such powers being inferred in the case of a trading company unless expressly prohibited in the Memorandum of Association; whilst non-trading companies have no such implied power and so must obtain in the Memorandum of Association express power to borrow; but even where borrowing powers exist, the Articles may limit the amount and manner of borrowing.

Upon the issue of registered debentures, stamp duty is payable on the amount secured (including premium on redemption) as follows—

	s.	*d.*
Exceeding £25 but not exceeding £50	2	6
Exceeding £50 and not exceeding £300 for each £50 or fraction thereof	2	6
Exceeding £300 for every £100 or fraction thereof	5	0

[1] If created by an insolvent company for a past debt within twelve months of the commencement of liquidation, the charge is void, but the loan is valid and carries interest at 5 per cent per annum. The Treasury may by order alter the rate. (Sect. 322.)

Mutatis mutandis, the entries are similar to those in respect of shares.

Illustration. X, Ltd., issues ten £100 debentures at 105, payable £20 on application and £85 on allotment. Show Journal entries (ignoring narratives).

JOURNAL

	£	£
Cash . . . . . . *Dr.*	200	
To Application and Allotment (Debentures)		200 (*a*)
Application and Allotment (Debentures) . . . . . . *Dr.*	1,050 (*a*)	
To Debentures		1,000
,, Debentures Premium[1] . .		50
Cash . . . . . . *Dr.*	850	
To Application and Allotment (Debentures)		850 (*a*)

Items marked (*a*) cancel themselves out in the Ledger.

Illustration. X, Ltd., issues ten £100 debentures at 95 per cent, payable £20 on application and £50 on allotment: £25 call. Show Journal entries (ignoring narratives).

JOURNAL

	£	£
Cash . . . . . . *Dr.*	200	
To Application and Allotment (Debentures)		200 (*a*)
Application and Allotment (Debentures) . . . . . . *Dr.*	700 (*a*)	
Debenture Discount[1] . . . . *Dr.*	50	
To Debentures		750
Cash . . . . . . *Dr.*	500	
To Application and Allotment (Debentures)		500 (*a*)
Call Account (Debentures) . . *Dr.*	250 (*b*)	
To Debentures		250
Cash. . . . . . . *Dr.*	250	
To Call Account (Debentures) .		250 (*b*)

Items marked (*a*) and (*b*) cancel themselves out in the Ledger.

A premium on debentures, except in a company operating under the Double Account System, is legally available for

[1] Note that the discount and premium entries are entered with those made on *allotment*.

distribution as dividend unless the Articles forbid, although such application is contrary to sound financial practice.

The law requires that the discount on debentures be separately shown in the Balance Sheet till written off, and in consequence this entails the disclosure of the debenture liability at the nominal value, **i.e. gross.** In the above illustration, the Balance Sheet will show the debentures at £1,000 as a liability and the discount of £50 on the assets side (unless written off). The amount of discount must be disclosed in the Annual Return.

In all cases a debenture containing a charge must be registered with the Registrar of Companies within 21 days of the creation of the charge.

The Companies Act, 1948, provides that the following items (appropriate to the matters under discussion) shall be shown separately in the Balance Sheet till written off—

1. Discount on debentures.
2. Discount on shares.
3. Commission on shares *and* debentures.
4. Expenses of issue of shares *and* debentures.

It will be observed that whilst commission on both shares and debentures may be merged (similarly with expenses) the discounts must be shown separately.

Issue of Shares and Debentures to Vendor. The opening entries will be dealt with in Chapter XXIII (*f*), but it is necessary, to complete the explanation of entries for shares and debentures, to refer very briefly to the discharge of the debt to the vendor of a business acquired by the company.

A student will have no difficulty in understanding that the vendor will be a creditor in respect of the purchase consideration which with goodwill, if necessary, will be exactly equal to the *net* assets acquired. If the vendor receives his debt in cash there will be required a credit entry in the Cash Book for the payment, the vendor being debited. If, however, shares and/or debentures are allotted, an entry in Share Capital Account and/or Debentures Account takes the place of the entry in the Cash Book. So far as relates to the vendor's shares and/or debentures there will be no need for Application and Allotment and Call Accounts.

Illustration. The purchase consideration payable to the vendor is £2,000, to be discharged by the issue of 1,100 shares of £1, credited as fully paid, and £1,000 7 per cent debentures at a discount of 10 per cent.

Show the Journal entries in the books of the company.

JOURNAL

			£	£
	Vendor . . . . . . *Dr.*		1,100	
	To Share Capital[1] . . .			1,100
	Being the issue of 1,100 shares of £1 each fully paid in part discharge of purchase consideration per directors' resolution dated.......*vide* Minute Book, p.			
	Vendor . . . . . . *Dr.*		900	
	Discount on Debentures . . *Dr.*		100 (*a*)	
	To 7% Debentures . . .			1,000 (*b*)
	Being the issue of £1,000 debentures at 90% in final discharge of purchase consideration per directors' resolution dated..........*vide* Minute Book, p. ...			

Assuming that the vendor sold to the company sundry assets worth £1,850, excluding goodwill, for £2,000, the initial entry would be—

JOURNAL

			£	£
	Goodwill . . . . . . *Dr.*		150	
	Sundry Assets . . . . . *Dr.*		1,850	
	To Vendor[2]			2,000
	Being assets taken over from Vendor as per purchase agreement dated			

The Balance Sheet will be—

BALANCE SHEET AS AT ....

	£		£
Authorized Capital .		Sundry Assets . . .	1,850
Issued Share Capital—		Goodwill . . .	150
1,100 Shares of £1 each fully paid . . .	1,100	Discount on Debentures .	100
7% Debentures . .	1,000		
	£2,100		£2,100

[1] Particulars of the allotment stating the consideration therefor must be notified to the Registrar of Companies within one month of allotment.

(*a*) Shown as "asset" till written off.

(*b*) Shown as liability for £1,000.

In examination work the two Journal entries may be combined, although (unless pressed for time) it is preferable that the student write them up separately.

[2] Upon the issue of shares and debentures the debits from the Journal will eliminate the above credit.

The company, in practice, would probably issue further shares and this would be essential if the vendor is to receive part or all of the purchase consideration in cash, the entries for which will be made according to the principles already outlined.

Issue of Debentures as Collateral Security for a Loan. A company may issue its own debentures as collateral security for a loan or for a bank overdraft by way of total or partial security therefor.

A collateral security is one which can be realized by the party in possession in the event of the original loan not being repaid at the due date or in the event of other breach of agreement between the parties. On repayment of the loan the collateral security is at once released.

Thus, in the case of debentures issued by a company as collateral, these debentures will normally be withdrawn if the loan is repaid at the due date.

Sect. 90 (3) of the Companies Act, 1948, however, provides that debentures deposited as security for advances from time to time on current account or otherwise shall not be considered to have been redeemed *by reason only* of the account of the company having ceased to be in debit whilst the debentures still remain deposited.

There are two ways of dealing with these debentures in the accounts of the company.

1. No entry whatsoever is made in the financial books of the company in respect of such debentures, their existence being recorded simply by a note on the Balance Sheet under the liability secured.

Illustration. Aldine, Ltd., obtains an overdraft from its bankers of £20,000, giving as collateral security £25,000 debentures. The Balance Sheet of Aldine, Ltd., will appear as follows—

BALANCE SHEET AS AT ....

Liabilities Side	£
Bank Overdraft	20,000
(Collaterally secured by an issue of £25,000 debentures.)	

2. By recording the transaction in the financial books of the company. The debentures issued will be debited to Debentures Suspense Account and credited to Debentures Account. The Debentures Suspense Account will appear as an asset on the Balance Sheet. Upon repayment of the loan the entries will be reversed, Debentures Account being debited and Debentures Suspense Account credited.

Illustration. Taking the same details as in the above illustration, the entries on issue are—

JOURNAL

			£	£
	Debentures Suspense . . . . *Dr.*		25,000	
	To Debentures			25,000
	Being debentures issued collaterally to X Bank to secure an overdraft of £20,000 as per directors' resolution dated...... *vide* Minute Book, p.			

No question of interest on DEBENTURES arises in such a case: the interest on Bank Overdraft is dealt with in the normal manner.

Debenture Interest. Debenture interest is the interest payable by the borrowing company in return for money lent on debenture; it constitutes a charge against profits whether profits are earned or not. Upon payment of debenture interest, the company is bound to deduct income tax at the standard rate from the interest, and account for the tax deducted to the Inland Revenue. (See Chapter XXI.)

Book-keeping Entries. 1. Debit the Debenture Interest Account with the GROSS amount of the interest.

2. Credit the net amount to Debenture-holders.

3. Credit the income tax on the interest to Income Tax Account.

The Debenture-holders Account will be debited upon the payment by the company, and at the end of the accounting period the Debenture Interest Account will be transferred to the debit of Profit and Loss Account.

Illustration. Borrowers, Ltd., has 400 5 per cent debentures of £100 each outstanding, the interest being payable half-yearly on 5th April and 5th October. The company's year ends on 5th April, and the liability for Income Tax, based on the profits, including debenture interest added back, is £2,500. Show Journal entries in the company's books. Take Income Tax at 9s. in the £.

In addition, write up the necessary ledger accounts.

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			£	£
19.. Oct. 5	Debenture Interest . . . . *Dr.*		1,000	
	To Debenture-holders . . .			550
	,, Income Tax			450
	Being half-year's debenture interest and income tax thereon at 9s. in £			
19.. April 5	Debenture Interest . . . . *Dr.*		1,000	
	To Debenture-holders . . .			550
	,, Income Tax			450
	Being half-year's debenture interest and income tax thereon at 9s. in £			

Dr. DEBENTURE INTEREST *Cr.*

19.. Oct. 5	To Half-year's Interest[1] .		£ 1,000	19.. April 5	By Profit and Loss Account		£ 2,000
19.. April 5	" " " [1] .		1,000				

Dr. INCOME TAX *Cr.*

19.. April 5	To Commissioners of Inland Revenue: Liability for the Year[2] .		£ 2,500	19.. Oct. 5	By Debenture Interest Account . .		£ 450
				19.. April 5	" " "		450
					" Profit and Loss Appropriation Account .		1,600
			£2,500				£2,500

Dr. DEBENTURE-HOLDERS *Cr.*

19.. Oct. 5	To Cash		£ 550	19.. Oct. 5	By Debenture Interest Account . .		£ 550
19 April 5	" "		550	19.. April 5	" " "		550
			£1,100				£1,100

Dr. COMMISSIONERS OF INLAND REVENUE *Cr.*

				19.. April 5	By Income Tax Account .		£ 2,500

Debenture Interest and Tax Thereon in Final Accounts. Students will often find in examination problems involving a Profit and Loss Account and Balance Sheet an item in the Trial Balance as follows—

Half-year's debenture interest, less tax at 9s., £660.

This item shows that only the cash payment made to the debenture-holders has been recorded in the books, and hence it is necessary to find the gross figure, which is £1,200. The Profit and Loss Account will be debited with the *full* year's interest (gross), £2,400, together with the *net* balance on Income Tax Account, the Balance Sheet showing the liability to the debenture-holders £660, and to the Inland Revenue on the assessment figure. The result is to show the liability under its true heading. Assuming the tax liability of the company to be £1,920, the following entries will appear in the books of the company—

Dr. PROFIT AND LOSS ACCOUNT *Cr.*

	To Debenture Interest .		£ 2,400				
	" Income Tax[3] . .		840				

[1] The gross and tax may be entered separately. (See next illustration.)

[2] Debit for the tax payable per assessment on profits, which will include the amount of debenture interest added back.

[3] Actually this may appear in the Appropriation Section

Dr. INCOME TAX Cr.

		£			£
To Commissioners of Inland Revenue: Liability for the year . . .		1,920	By Debenture Interest Account . . .		1,080
			,, Profit and Loss Appropriation Account[1]		840
		£1,920			£1,920

Dr. DEBENTURE INTEREST Cr.

		£			£
To Debenture-holders for half-year's interest .		660	By Profit and Loss Account.		2,400
,, ,, ,,		660			
,, Income Tax[2] [9s. in £ on £2,400] .		1,080			
		£2,400			£2,400

Dr. DEBENTURE-HOLDERS Cr.

		£			£
To Cash . . .		660	By Debenture Interest Account . . .		660
,, Balance .	c/d	660	,, ,, ,,		660
		£1,320			£1,320
			By Balance . .	b/d	660

BALANCE SHEET

Liabilities Side	£
Reserve for future Income Tax .	1,920
Current Liabilities:	
Creditors (includes Debenture-holders)	660

Other important problems arise on this topic, but as they involve a knowledge of matters not yet explained, they will be dealt with at the same time as the problems with which they are connected.

Redemption of Debentures. Where debentures are redeemable the method usually adopted to safeguard the interests of the debenture-holders is to require a Sinking Fund to be created out of profits and a sum equivalent thereto invested in outside securities or in an insurance policy. This usually takes place where the debentures are redeemable at a *fixed* date.

Instead of requiring a fixed appropriation to a Sinking Fund, provision is sometimes made whereby the company is precluded from paying dividends over and above a certain fixed rate. This

[1] *Net* balance, as mentioned above

[2] In practice the transfer to Income Tax Account would be made at the date of each accrual; in this instance, half-yearly.

proviso will not of itself ensure the reasonable certainty that the CASH will be forthcoming, so that a further provision is advisable to compel the setting aside of moneys, e.g. by an insurance policy, so that cash may be available when required for debenture redemption.

The three ways of discharging a debenture debt are—

1. By payment to the holders, either at par or at a premium, at the *expiry* of a specified period or at the company's option at a date *within* a specified period.

2. By purchase of the debentures in the open market usually permitted only if the market price falls to, or below, a specified figure, e.g. in the case of £100 debenture stock if the market price falls to, or below, say 97.

3. By payment year by year of a certain portion, say one-tenth, of the total debenture debt by "drawings," that is, by withdrawal from a sealed drum of slips, each representing a number of debentures to be repaid.

Payment of Debentures at Maturity. The practice is to set aside annually an equal sum which, with compound interest at a rate decided upon, will amount to the sum required to pay off the debentures at the date fixed for redemption. Simultaneously with the above appropriation, a like sum of money is invested in first-class fixed income securities together with the interest received therefrom year by year, so that in each Balance Sheet of the company until the debentures are redeemed, will appear the debentures and the Sinking Fund as liabilities and the Sinking Fund Investment as an asset.

It is necessary to distinguish carefully between the two items; the first is merely a certain amount of undistributed profit kept on one side and not available for immediate distribution to the members, but nevertheless, still *profits of the company*; whilst the investment of the same amount is merely an asset of the company invested "outside" so that it becomes an available cash asset when required.

In making calculations for the amount to set on one side the actual figure is obtainable from Tables. Consideration must be given to the cost of purchase, income tax on the interest (the rate of which obviously cannot be accurately prognosticated), possible depreciation of the investment at the date when it is necessary to realize it for the purpose of providing cash to repay the debenture-holders. For these reasons, many companies provide the cash by taking out an insurance policy, the yearly premiums being the equivalent of the yearly investment in securities; others prefer to take a security which has a redemption date coinciding with that of the date on which the repayment of the debentures falls due.

The book-keeping entries are at the date of the creation of Fund—

(1) Debit Profit and Loss Appropriation Account[1] Credit Sinking Fund Account	with the yearly sum to be set aside.
(2) Debit Sinking Fund Investment Account Credit Cash	with the yearly sum invested.

This process will be repeated each year.

In addition, the annual interest will have to be dealt with thus—

(1) Debit Cash Credit Sinking Fund Account	on receipt of Interest.
(2) Debit Sinking Fund Investment Account Credit Cash	on reinvestment of Interest.

Upon realization and redemption the entries are—

(1) Debit Cash. Credit Sinking Fund Investment Account.	on sale of investments.
(2) Debit Debentures Account. Credit Cash.	on redemption of debentures.
(3) Debit Sinking Fund Account. Credit Reserve.	with part of Sinking Fund no longer required.

Where debentures are redeemed at a *premium*, the additional entries necessitated are as follows—

(1) Debit Premium on Redemption of Debentures Account.
Credit Debentures Account.
(2) Debit Sinking Fund Account.
Credit Premium on Redemption of Debentures Account.

The converse applies in the case of a redemption at a *discount*.

Alternatively, the balance of Debentures Account may be transferred to the credit of Debenture-holders Account, and upon redemption cash debited thereto.

Illustration. Ushant, Ltd., has made an issue of £10,000 5 per cent debentures at par on 1st January, 1951, the terms of which include that the company must provide a Sinking Fund for redemption on 31st December, three years later. It is ascertained from Tables that the annual sum to be set on one side for three years at 4 per cent (rate chosen) compound interest to accumulate to £1 is £·320348. The first investment to be made on 31st December following issue.

Show Journal entries for the first two years and Ledger Accounts for the three years, ignoring tax and expenses.

[It should first be mentioned that so short a life is unlikely, the period being thus chosen so as to show all the transactions. Secondly, the fund will not come into being until the end of the first year and no interest will arise till the end of the second year, i.e. on the first investment.]

The amount to be set aside is—

$$10{,}000 \text{ times } {\cdot}320348 = £3203{\cdot}48$$

[1] The amount in question is *NOT a charge* against profits.

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			£	s.	d.	£	s.	d.
1951 Dec. 31	Profit and Loss Appropriation *Dr.*		3,203	9	7			
	To Sinking Fund . . .					3,203	9	7
	Being annual sum set aside out of profits.							
	Sinking Fund Investment . *Dr.*		3,203	9	7			
	To Cash					3,203	9	7
	Being annual sum invested at 4% p.a.							
1952 Dec. 31	Cash . . . . . . *Dr.*		128	2	10			
	To Sinking Fund . . .					128	2	10
	Being interest received on £3,203 9s. 7d. at 4% per annum							
	Sinking Fund Investment . *Dr.*		128	2	10			
	To Cash					128	2	10
	Being investment of interest received.							
	[At this date entries will, in addition, be made similar to those in 1951]							

Dr. 5% DEBENTURES *Cr.*

			£	s.	d.				£	s.	d.
1953 Dec. 31	To Cash: Debentures redeemed		10,000	0	0	1951 Jan. 1	By Cash: £10,000 Debentures issued at par .		10,000	0	0

Dr. SINKING FUND INVESTMENT *Cr.*

			£	s.	d.				£	s.	d.
1951 Dec. 31	To Cash . .		3,203	9	7	1951 Dec. 31	By Balance . .	c/d	3,203	9	7
1952 Jan. 1	To Balance . .	b/d	3,203	9	7	1952 Dec. 31	By Balance .	c/d	6,535	2	0
Dec. 31	,, Cash . .		3,203	9	7						
	,, Interest at 4% p.a. on £3,203 9s. 7d. for one year . .		128	2	10						
			£6,535	2	0				£6,535	2	0
1953 Jan. 1	To Balance . .	b/d	6,535	2	0	1953 Dec. 31	By Cash . .		10,000	0	0
Dec. 31	,, Cash[1] . .		3,203	9	7						
	,, Interest at 4% p.a. on £6,535 2s. for one year[1] . .		[2]261	8	5						
		£	10,000	0	0			£	10,000	0	0

[1] As redemption takes place the same day, these items would obviously not be actually invested.

[2] The calculation of interest is strictly £261 8s. 2d., as the tables used are given to six decimal places only.

Dr. SINKING FUND *Cr.*

			£	s.	d.				£	s.	d.
						1951 Dec. 31	By Profit and Loss Appropriation Account .		3,203	9	7
						1952 Dec. 31	" Profit and Loss Appropriation Account .		3,203	9	7
							" Cash: Interest		128	2	10
1953 Dec. 31	To Transfer to General Reserve .		10,000	0	0	1953 Dec. 31	" Profit and Loss Appropriation Account .		3,203	9	7
							" Cash: Interest		261	8	5
		£	10,000	0	0			£	10,000	0	0

BALANCE SHEET

(as relates to Debentures immediately *prior* to their redemption)

	£		£
£10,000 5% Debentures redeemedable on 31st December, 1953 . .	10,000	Cash	10,000
Sinking Fund . . .	10,000		

It may be here noted that frequently the term "Debenture Redemption Account (or Fund)" is employed instead of "Sinking Fund."

Although it is not usual to redeem debentures until the completion of the build up of the Sinking Fund, problems occur frequently in examinations which require the entries for redemption when part of the debentures are paid off out of the Redemption Fund Investments.

It will be clear that in connection with debenture redemption there will normally arise two distinct profits or losses, viz.—

1. Profit or loss on the *realization* of the Sinking Fund Investments.
2. Profit or loss on the *redemption* of the debentures.

Unless the question indicates to the contrary, both the above results should be transferred to the Sinking Fund (or Debenture Redemption Account). After this is done the balance of the Fund will be made up of—

1. The amount representing the nominal amount of debentures redeemed.
2. The amount representing the book value of the remaining Debenture Redemption Fund Investments (including any cash balance where the investments sold have produced more than the sum required for redemption).

Item (1) will be transferred to General Reserve (or as the question indicates), leaving item (2) as the final balance.

Illustration. The Debenture Redemption Account of X, Ltd., stood at £8,000 represented by £10,000 (nominal) investments. The debentures stood at £30,000 and the company sold £6,000 (nominal) investments at 84 for the purpose of redeeming £5,000 debentures at 100½. Show Ledger Accounts, ignoring interest and brokerage.

Dr. DEBENTURES *Cr.*

		£			£
To Cash		5,025	By Balance	b/d	30,000
,, Balance	c/d	25,000	,, Debenture Redemption Account, Premium on Redemption		25
	£	30,025		£	30,025
			By Balance	b/d	25,000

Dr. DEBENTURE REDEMPTION *Cr.*

		£			£
To Premium on Redemption of £5,000 Debentures		25	By Balance	b/d	8,000
,, General Reserve (1)		5,000	,, Profit on Realization of Investments		240
,, Balance	c/d	3,215			
		£8,240			£8,240
			By Balance (2)	b/d	3,215

Dr. DEBENTURE REDEMPTION FUND INVESTMENT *Cr.*

		Nominal	Price				Nominal	Price	
		£		£			£		£
To Balance	b/d	10,000	80	8,000	By Cash		6,000	84	5,040
,, Debenture Redemption Account—Profit on Realization				240	,, Balance	c/d	4,000	80	3,200
	£	10,000		£8,240		£	10,000		£8,240
To Balance (2)	b/d	4,000	80	3,200					

Dr. GENERAL RESERVE *Cr.*

					£
			By Debenture Redemption Account		5,000

Dr. CASH *Cr.*

		£			£
To Debenture Redemption Fund Investment Account		5,040	By Debentures Account		5,025
			,, Balance	c/d	15
		£5,040			£5,040
To Balance (2)	b/d	15			

Note (1) The transfer to General Reserve equals the nominal amount of debentures redeemed.

Note (2). The balance on Debenture Redemption Account equals the book value of investments, viz. investments £3,200, PLUS cash £15. The latter is merely the balance remaining by reason of the sale of investments providing slightly more cash than is required for redemption.

Insurance Policy Method. The principle outlined above applies to this method, except that no interest is receivable during the period. Accordingly, the instalments (i.e. the premiums payable) will be less than the total sum of the policy divided by the number of premiums, e.g. if the amount to be provided is £5,000 in five years, the premium will be considerably less than £1,000 seeing that no interest as such is receivable; on the other hand it will be higher than the sum set aside by the investment method, because the latter will presuppose a rate of interest of, say, 3 per cent to 3½ per cent, whereas the yearly premiums will be based at a rate approximating to 2½ to 3 per cent.

Again, the investment made into securities can be realized at any time, subject to any depreciation or appreciation in value, whereas if the policy is surrendered there will be a very serious loss entailed. This, however, may be avoided by obtaining a loan on the security of the policy.

The premium must be paid at the commencement of the first year, as one year must elapse after the last premium is paid before the policy moneys fall due.

The entries upon the yearly appropriation and payment of premium will be as follows—

1. Debit Profit and Loss Appropriation Account.
   Credit Debenture Redemption Account.
2. Debit Debenture Redemption Policy Account.
   Credit cash.

Upon realization and redemption—

1. Debit cash.
   Credit Debenture Redemption Policy Account
2. Debit Debentures Account.
   Credit cash.
3. Debit Debenture Redemption Account.
   Credit Reserve Account.

Where debentures are redeemed at a *premium*, the entries necessitated are as follows—

(1) Debit Premium on Redemption of Debentures Account.
    Credit Debentures Account.

(2) Debit Debenture Redemption Account.
    Credit Premium on Redemption of Debentures Account.

The converse applies in the case of a redemption at a *discount*.

As the amount receivable will be in excess of the sum of the premiums, there will be a profit at the end of the period on the policy, unless a transfer is made yearly on the basis of an estimated rate of interest earned, in which case the yearly transfer would be—

Debit Debenture Redemption Policy Account.
Credit Debenture Redemption Account.

Illustration. Ushant, Ltd., has made an issue of £10,000 5 per cent debentures on 1st January, 19.., the terms of which include that the company must provide a Sinking Fund for redemption on 31st December, 19.. (three years later). The directors decide to take out an insurance policy to provide the necessary cash, the annual premium being £3,141 1s. 5d., on which the return is 3 per cent per annum compound interest.

Show Ledger Accounts.

Dr. 5% DEBENTURES *Cr.*

			£				£
Year 3 (end)	To Cash . . .		10,000	Year 1 (commencement)	By Cash . . .		10,000

Dr. DEBENTURE[1] REDEMPTION *Cr.*

			£	s.	d.				£	s.	d.
						Year 1 (end)	By Profit and Loss Appropriation Account . .		3,141	1	5
							,, Debenture Redemption Policy Account— Interest at 3% p.a. on £3,141 1s. 5d. for one year . .		94	4	8
									3,235	6	1
						2 (end)	By Profit and Loss Appropriation Account . .		3,141	1	5
							,, Debenture Redemption Policy Account— Interest at 3% p.a. on £6,376 7s. 6d. for one year . .		191	5	10
Year 3 (end)	To General Reserve		10,000	0	0	3 (end)			6,567	13	4
							By Profit and Loss Appropriation Account . .		3,141	1	5
							,, Debenture Redemption Policy Account— Interest at 3% p.a. on £9,708 14s. 9d. for one year . .		291	5	3
		£	10,000	0	0			£	10,000	0	0

[1] These accounts will be balanced off yearly in the usual way.

Dr. DEBENTURE[1] REDEMPTION POLICY Cr.

		£	s.	d.			£	s.	d.
Year 1 (commencement)	To Cash—Premium .	3,141	1	5					
(end)	" Debenture Redemption Account—Interest .	94	4	8					
		3,235	6	1					
Year 2 (commencement)	To Cash—Premium .	3,141	1	5					
(end)	" Debenture Redemption Account—Interest .	191	5	10					
		6,567	13	4					
Year 3 (commencement)	To Cash—Premium	3,141	1	5	Year 3 (end)	By Cash .	10,000	0	0
(end)	" Debenture Redemption Account—Interest .	291	5	3					
	£	10,000	0	0		£	10,000	0	0

Dr. CASH (*re* REDEMPTION) Cr.

		£			£
Year 3 (end)	To Debenture Redemption Policy Account .	10,000	Year 3 (end)	By 5% Debentures Account	10,000

It will be observed that the principles enumerated are precisely those discussed in Chapter VII, so far as they relate to the construction of the accounts for the amortization of an asset. The balance of the Debenture Redemption Account upon the repayment of debentures becomes a free reserve, whereas the Asset Amortization Account must be used to write down an asset. (See page 184.)

Redemption by Annual Drawings. The repayments taking place annually preclude the building up of a Sinking Fund and investments to accumulate to the required sum due on a fixed date, so that it is usual to restrict the rate of dividends on ordinary shares to a certain percentage until the final repayment or to permit the rate of dividend to increase as the debenture debt diminishes. The entries required are: debit debentures, credit cash with the yearly drawings.

Debenture Discount. Where debentures have been issued at a discount the prudent company will write off to Profit and Loss Appropriation Account a proportion year by year, although it is not legally necessary unless the company's own provisions require it.

[1] These accounts will be balanced off yearly in the usual way.

The two methods usually employed are (1) to write off an amount yearly, proportionate to the life of the debentures, e.g. if the maturity of the debentures is ten years after issue, one-tenth of the debenture discount will be written off; or (2) to write off discount proportionate to the debenture debt outstanding at the commencement of each year less repayments, if any, during that year.

Illustration. A, Ltd., issues £10,000 debentures on 1st January, 19.., at a discount of 5 per cent repayable in annual drawings of £2,000, commencing 31st December following. The company's year ends on 31st December. Show the amounts to be written off in the five years, assuming that the company decides to write off Debenture Discount Account during the life of the debentures.

METHOD 1.

One-fifth of £500 = £100 per annum.

METHOD 2.

Amount of debentures outstanding at the commencement of each year, viz.:

Year	£	*Proportion*	*Amount* £	s.	d.
1	10,000	$= \frac{10}{30} \times 500 =$	166	13	4
2	8,000	$= \frac{8}{30} \times 500 =$	133	6	8
3	6,000	$= \frac{6}{30} \times 500 =$	100	0	0
4	4,000	$= \frac{4}{30} \times 500 =$	66	13	4
5	2,000	$= \frac{2}{30} \times 500 =$	33	6	8
	30,000		£500	0	0

The Ledger Account for Debenture discount as dealt with by Method 2 is as follows—

Dr. DEBENTURE DISCOUNT *Cr.*

Year			£	s.	d.	Year			£	s.	d.
1	To Debentures .		500	0	0	1	By Profit and Loss Appropriation Account .		166	13	4
							„ Balance . . .	c/d	333	6	8
			£500	0	0				£500	0	0
2	To Balance . .	b/d	333	6	8	2	By Profit and Loss Appropriation Account		133	6	8
							„ Balance . . .	c/d	200	0	0
			£333	6	8				£333	6	8
3	To Balance . .	b/d	200	0	0	3	By Profit and Loss Appropriation Account .		100	0	0
							„ Balance . . .	c/d	100	0	0
			£200	0	0				£200	0	0
4	To Balance . .	b/d	100	0	0	4	By Profit and Loss Appropriation Account .		66	13	4
							„ Balance . . .	c/d	33	6	8
			£100	0	0				£100	0	0
5	To Balance . .	b/d	£33	6	8	5	By Profit and Loss Appropriation Account .		£33	6	8

Illustration. Debenture discount is £120 in respect of £6,000 debentures issued on 1st April, 1950, repayable by three equal drawings of £2,000 each. The company makes its accounts up to 31st December. The calculation for the amount of discount to be written off is as follows—

Year ended			Amount written off	
	£	£	£	£
31st Dec., 1950	6,000 × $\frac{3}{4}$ [i.e. 1st April to 31st Dec.]		4,500 $\frac{45}{120}$ × 120 =	45
„ 1951	6,000 × $\frac{1}{4}$ [i.e. 1st Jan. to 31st Mar.]	1,500		
	4,000 × $\frac{3}{4}$ [i.e. 1st April to 31st Dec.]	3,000		
			4,500 $\frac{45}{120}$ × 120 =	45
1952	4,000 × $\frac{1}{4}$ [as in 1948]	1,000		
	2,000 × $\frac{3}{4}$ [as in 1948]	1,500		
			2,500 $\frac{25}{120}$ × 120 =	25
1953	2,000 × $\frac{1}{4}$ [i.e. 1st Jan. to 31st Mar.]		500 $\frac{5}{120}$ × 120 =	5
			12,000	£120

It is assumed that the first repayment takes place on 1st April, 1951.

The writing off in the above illustration involves four accounting periods, the first and the last being respectively for 9 months (of 1950) and 3 months (of 1953), during which time debentures are outstanding. After the first full year operates (i.e. 1951) the ratios decrease by £2,000.[1]

The position in regard to an issue of debentures at a premium or at a discount demands further attention. The principles involved are similar, so that the question of an issue at a premium will also be considered. Where debentures are issued at a premium it is usually because the interest payable thereon is higher than that reasonably obtainable on a security of that kind, after making due allowance for business risk. Therefore, the real burden to the company should be that arising from a payment of interest at the normal rate so that the premium on issue is not a true profit at all. If the debentures are redeemable at a fixed date the premium charged should be the PRESENT WORTH of the DIFFERENTIAL interest, so that the difference between the ACTUAL and NORMAL rate of interest will exhaust the amount of the premium by the expiry of the term of the debentures.

For instance, if a company issues £1,000 debentures (ruling rate of interest being 4 per cent) they may be issued at a premium with a higher rate of interest than 4 per cent or at a discount with a lower rate of interest than 4 per cent having regard to date of maturity.

Illustration. Assuming that the £1,000 debentures are redeemable at the expiry of five years the issue price would be (on a 4 per cent *yield* basis, but a 6 per cent interest *payment* basis) at a premium of £89·03 to the nearest second place of decimals or *in practice £89.*

[1] If method (1) is used, the amounts written off will be £30, £40, £40, and £10 respectively.

The above figure may be obtained from an Annuity Table. The book-keeping entry will be—

	£	£
Debit Cash	1,089·03	
Credit Debentures . . .		1,000
,, Premium		89·03

As the interest on £1,089·03 at 4 per cent per annum is really £43·56 annually, debenture interest should be debited therewith; the difference between such amount and the 6 per cent on £1,000 = £60 is virtually a part repayment of the premium, so that at the beginning of the second year the amount of premium has been returned to the extent of £16·44, leaving premium outstanding at £72·59 (i.e. £89·03 less £16·44). Hence, in the second year the return of premium will be the difference between the £60 and 4 per cent interest on £1072·59 (£42·90), viz. £17·10, thus continuing the process until the end of the fifth year, when £1,000 remains for payment.

The book-keeping entries for each of the five years will be—

	Dr. Debenture Interest [per next column]	4% on	*Dr.* Premium	*Cr.* Cash	Balances *Cr.* Debentures	Balances *Cr.* Premium
	£	£	£	£	£	£
Commencement of 1st year					1,000	89·03
End of 1st year	43·56	(1,089·03)	(*b*) 16·44	60	1,000	(*a*) 72·59
2nd	42·90	(1,072·59)	(*d*) 17·10	60	1,000	(*c*) 55·49
3rd	42·22	(1,055·49)	(*f*) 17·78	60	1,000	(*e*) 37·71
4th	41·51	(1,037·71)	(*h*) 18·49	60	1,000	(*g*) 19·22
5th	[1] 40·78	(1,019·22)	(*j*) 19·22	60	1,000	(*i*) nil
			£89·03			

	£		£	£
(*a*)	89·03	*less* repayment of	(*b*) 16·44 =	72·59
(*c*)	72·59	,, ,,	(*d*) 17·10 =	55·49
(*e*)	55·49	,, ,,	(*f*) 17·78 =	37·71
(*g*)	37·71	,, ,,	(*h*) 18·49 =	19·22
(*i*)	19·22	,, ,,	(*j*) 19·22 =	nil

The results may now be compared thus—

(*a*) By the above method. (*b*) By taking the premium as profit.

	(a) *Debenture Interest*	(b) *Debenture Interest*	(b) *Premium*
	£	£	£
Year 1	43·56	60	89·03
,, 2	42·90	60	
,, 3	42·22	60	
,, 4	41·51	60	
,, 5	40·78	60	
Total (Debit)	£210·97	(Debit) £300 [*net Debit* £210·97]	(Credit) £89·03

There is no LEGAL necessity for treatment on strict theoretical lines, but the method is scientifically sound and in examination work the principle should be mentioned and (time permitting) illustrated. No provision exists in the Companies Act, laying down

[1] Actually 40·77 [·01 error arises by taking two places of decimals only].

any particular treatment of PREMIUMS on debentures, but only as regards DISCOUNTS.

Illustration. The same principle applies in treating debentures at a discount. The company in offering debentures at a discount would have to compute on a 4 per cent basis with interest at 2 per cent to permit of the same figures being employed. Just as, in the previous illustration, the 2 per cent extra interest was merged in the premium, so the 2 per cent less interest will be merged in the discount. Hence, as the premium for the differential 2 per cent was 89·03 per £1,000, so the discount will be the same figure; therefore, the debentures will be issued on that basis, the entry on receipt being—

	£	£
Debit Cash	910·97	
,, Discount on Debentures . .	89·03	
Credit Debentures		1,000

The law, it will be remembered, insists on the discount on debentures being shown in the Balance Sheet as a separate item (and the debentures as a consequence at the gross figure) The reverse process now applies, viz. the true rate of interest is £20 [2 per cent on £1,000] plus £16·44 to make up 4 per cent on £910·97 [£36·44], so that the sum of £36·44 will be debited to Profit and Loss Account, Cash and Debenture Discount being respectively credited with £20 and £16·44. Although the law does not require an ACTUAL writing off of the debenture discount, it must be shown in the Balance Sheet TILL written off.

The entry, therefore, for the first year will be—

	£	£
Debit Debenture Interest	36·44	
Credit Cash		20·00
,, Debenture Discount . . .		16·44

This process will be continued until the date for repayment of debentures.

The entries year by year will therefore be—

	Dr. Debenture Interest [per next column]	4% on	*Cr.* Debenture Discount	*Cr.* Cash	Balances *Cr.* Debentures	Balances *Dr* Debenture Discount
	£	£	£	£	£	£
Commencement of 1st year					1,000	89·03
End of 1st year	36·44	(*a*) (910·97)	16·44	20	1,000	72·59
2nd	37·10	(*b*) (927·41)	17·10	20	1,000	55·49
3rd	37·78	(*c*) (944·51)	17·78	20	1,000	37·71
4th	38·49	(*d*) (962·29)	18·49	20	1,000	19·22
5th	[1]39·22	(*e*) (980·78)	19·22	20	1,000	nil
			£89·03			

[1] Actually 39·23 [·01 error arises by taking two places of decimals only].

		£			£		£
(a)	Balance	1,000	*less*	Debenture Discount	89·03	=	910·97
(b)	,,	1,000	,,	,, ,,	72·59	=	927·41
(c)	,,	1,000	,,	,, ,,	55·49	=	944·51
(d)	,,	1,000	,,	,, ,,	37·71	=	962·29
(e)	,,	1,000	,,	,, ,,	19·22	=	980·78

The results may now be compared, thus—

(a) By the above method.
(b) By taking the discount as loss.

	Debenture Interest	*Discount* Dr.	*Discount* Cr.	*Debenture Interest*	*Discount*
	£	£	£	£	£
Year 1	36·44	89·03	16·44	20	
,, 2	37·10		17·10	20	
,, 3	37·78		17·78	20	
,, 4	38·49		18·49	20	
,, 5	39·22		19·22	20	89·03
Total (Debit)	£189·03	£89·03	£89·03	(Debit) £100 [*Total Debit* (Debit) £189·03]	£89·03

[The premium (and conversely for discount) is the present worth of the differential annuity of 2 per cent for five years, taking 4 per cent as the basic rate—

$$\text{Present worth} = 2 \times \frac{\left(1 - \frac{1}{(1\cdot04)^5}\right)}{\cdot04}$$

$$= 50\left(1 - \frac{1}{1\cdot21665}\right)$$

$$= £8\cdot903$$

The present worth of an annuity of £2 at 4 per cent for 5 years is £8·903, or £89·03 for an annuity of £20. The investor is, theoretically, prepared to pay £89·03 premium to receive, over and above 4 per cent on £1,000, five annual payments of £20 each (i.e. 2 per cent on £1,000).

Conversely, the investor would, in consideration of losing five annual payments of £20, require a rebate on the purchase price of £1,000 debentures on which he wants a 4 per cent yield, to the extent of £89·03.]

Purchase of Debentures in Open Market. This is the method adopted when it is desired to keep the debentures alive with a view to future reissue. They may be purchased as the investment on the Sinking Fund or a certain amount may be spent each year out of the liquid capital of the business, even where there is no specific obligation to redeem. If the purchase is made immediately after the interest has been paid the question of accrued interest will not, of course, enter into the calculations. In practice, however, the purchase will be made at a time when the market is most favourable, that is, when the market price is low. Where the debentures so purchased represent investments on the Sinking Fund, it is advisable to write off any premium or discount involved in the purchase price to the Sinking Fund, so that at the date of redemption the balance of Debenture Investment Account will equal the balance of the Debentures Account. If, however, the debentures are merely held as an investment in the ordinary course of the company's business, a Debentures Investment Account will be opened and treated as an Investment Account in the ordinary way.

It may be noted that, where there is a Sinking Fund in existence, debentures purchased in the open market are often utilized as the Sinking Fund Investment.

Treatment of Interest on Own Debentures. (1) *Where no Sinking Fund exists*, the interest will be credited either as a separate item to Profit and Loss Account or to Debenture Interest Account,[1] the net balance of the latter being transferred to the debit of Profit and Loss Account in the ordinary way.

(2) *Where a Sinking Fund is being built up*, if the debentures have been acquired either out of the proceeds of sale of Sinking Fund Investments or out of profit to the Sinking Fund, then inasmuch as such debentures will form part of the Sinking Fund Investments, the interest will be credited to the Fund, precisely as if the investments were outside investments. Obviously, the *debit* for such interest will be to Profit and Loss Account, as the latter account should include the interest on the *whole* of the debentures, i.e. those held by outsiders and those held by the company itself.

Profits and losses on Sinking Fund Investments will be dealt with on the same principle.

(3) *Where no Sinking Fund exists*, if the debentures are purchased for cancellation or redeemed by drawings, it is a common practice to transfer an amount equal to the debentures purchased for cancellation from Profit and Loss Account to General Reserve—ignoring interest—having the same effect as if a fund had been built up annually and upon redemption of the debentures transferred to General Reserve.

Should the purchase be made within the interest period, the price will be inclusive of accruing interest if bought "cum interest"; but if purchased "ex interest," the forthcoming interest is retained by the seller. In order to adjust the matter, the accrued interest at the date of purchase will be debited in the interest column of the Investment Account and the interest for the whole period credited in the interest column. Thus a credit is left covering the proportion of interest arising since the date of purchase of the debentures.

Illustration. X, Ltd., purchases on 1st April, 19. ., £200 nominal of its own 6 per cent debentures at 98½, brokerage and expenses being £1. A further purchase of £600 nominal was made on 31st October at 101½, brokerage and expenses being £2. Debenture interest is payable on 30th June and 31st December. Ignore income tax. Show Ledger Accounts.

(*a*) Included in the price is 3 months' interest at 6 per cent per annum on £200 = £3, so that of the £6 received £3 is "pure" interest.

(*b*) Included in the price is 4 months' interest (1st July to 31st October) at 6 per cent per annum on £600 = £12, so that out of the

[1] Either credited to Debenture Interest Received Account and transferred to Debenture Interest Paid Account, or credited direct to the latter account

Dr. OWN DEBENTURES INVESTMENT *Cr.*

Date	Particulars		Nominal	Interest	Capital	Date	Particulars		Nominal	Interest	Capital
19..			£	£	£	19.			£	£	£
April 1	To Cash—Purchase. £200 at 98½ = £197; Plus Expenses = 1; £198		200	(a) 3	195	June 30	By Cash—half-year's Interest on £200 at 6% per annum			(a) 6	
Oct. 31	,, Cash—Purchase. £600 at 101½ = £609; Plus Expenses = 2; £611		600	(b) 12	599	Dec. 31	,, Cash—half-year's Interest on £800 at 6% per annum			(b) 24	
							,, Balance	c/d	800		794
Dec. 31	,, Debenture Interest Received Account			15							
			£800	£30	£794				£800	£30	£794
19.. Jan. 1	To Balance	b/d	800		794						

(a) and (b). See notes towards bottom of page 852.

£24 received on 31st December there remains £12 "pure" interest, made up of—

	£
6 months' Interest at 6 per cent per annum on £200 . . .	6
2 months' Interest at 6 per cent per annum on £600 . . .	6
As per Investment Account	£12

If on 1st January, 19.., the £800 debentures are cancelled, the Investment Account will be debited with £6 and Profit and Loss on Cancellation of Debentures Account credited with £6, followed by a debit of £800 to Debentures and a credit of £800 to the above Investment Account.

This results as follows—

Dr. OWN DEBENTURES INVESTMENT *Cr.*

			Nominal £	£				Nominal £	£
19.. Jan. 1	To Balance .	b/d	800	794	19.. Jan. 1	By Debentures Account		800	800
	,, Profit and Loss on Cancellation of Debentures Account .			6					
			£800	£800				£800	£800

Dr. DEBENTURES *Cr.*

			£				£
19.. Jan. 1	To Debentures purchased and cancelled .		800	19.. Jan. 1	By Balance .	b/d	?

Dr. PROFIT AND LOSS ON CANCELLATION OF DEBENTURES *Cr.*

							£
				19.. Jan. 1	By Profit on purchase and cancellation of £800 Debentures[1]		6

Where debentures are purchased on the open market for immediate cancellation, the purchase price, if "cum interest," includes the accruing interest, and the portion of the price that relates to interest must be transferred to Debenture Interest Account. When the interest date is approaching, the price paid above par may be less than the amount represented by the accruing interest, so that what appears to be a premium on purchase may really be a discount.

Where the debentures are acquired "ex interest," the converse applies, and the debenture interest will have to be paid at the end of the period, but as, at the date of acquisition, the FULL period interest was deducted from the "cum interest" price, an adjustment

[1] This account should be left as a Reserve to cover possible subsequent losses until all the Debentures have been discharged. The balance of profit, if any, is usually utilized to eliminate expenses of issue and discount on Debentures if this has not already been done during the life of the Debentures.

in relief of interest against capital is required. This is necessary because the debenture interest on the debentures bought and cancelled does not cover the whole period, but the capital cost has been relieved to the extent of the interest for the full period by reason of the deduction of the interest for the full period from the price when the latter is quoted "ex interest."

Illustration. On 1st January, X, Ltd., has £12,000 6 per cent debentures. In accordance with the powers under the deed, the directors acquire in the open market for immediate cancellation debentures, as follows—

Mar. 1. £2,000 at 98
Aug. 1. £4,000 at 100¼
Dec. 15. £1,000 at 98½ ex interest

Debenture interest is payable half-yearly, 30th June and 31st December. Show Ledger accounts of Debentures, Debenture Interest, Profit and Loss on Cancellation. Strike a balance half-yearly—

1st Half-year.

Dr. DEBENTURES *Cr.*

19..			£	19..			£
Mar. 1	To Debentures purchased £1,960 ,, Profit and Loss on Cancellation of Debentures Account 40	(a)	2,000	Jan. 1	By Balance . .	b/d	12,000
June 30	,, Balance . .	c/d	10,000				
			£12,000				£12,000
				July 1	By Balance . .	b/d	10,000

Dr. PROFIT AND LOSS ON CANCELLATION OF DEBENTURES *Cr.*

19..			£	19..			£
June 30	To Reserve . .		60	Mar. 1	By Debentures Account . .	(b)	40
					,, Debenture Interest Account . .		20
			£60				£60

Dr. DEBENTURE INTEREST *Cr.*

19..			£	19..			£
Mar. 1	To Profit and Loss on Cancellation of Debentures Account		20	June 30	By Profit and Loss Account . .		320
June 30	,, Debenture-holders (Interest) Account		300				
			£320				£320

Dr. DEBENTURE-HOLDERS (INTEREST) *Cr.*

19..			£	19..			£
June 30	To Cash . . .		165	June 30	By Debenture Interest Account[1] . . [£10,000 at 6% per annum for six months]		300
	,, Income Tax (at 9s. in the £) .		135				
			£300				£300

[1] Alternatively, the net amount of £165 might be credited to this account and Tax debited to Debenture Interest Account.

NOTES—

(1) $a - b$ = £2,000 – £40 = £1,960 £2,000 Debentures at 98 = £1,960

(2) The true Debenture Interest on £2,000 from 1st Jan to 28th February at 6 per cent per annum . . . . = £20

The true Debenture Interest on £10,000 for ½ year to June 30th at 6 per cent per annum . . . = 300

Charged to Profit and Loss Account, as above . . . £320

(3) The par value of each £100 of Debentures plus accruing interest at 6 per cent per annum for 2 months (i e 1st Jan to 28th February) = £101. The Debentures were bought back at £98 only, leaving a profit on the £2,000 at 3 per cent = £60

2nd Half-year.

Dr DEBENTURES *Cr*

Date		Particulars			£	Date		Particulars		£
19						19				
Aug	1	To Debentures purchased			4,010	July	1	By Balance	b/d	10,000
Dec	15	,, Debentures purchased	£985			Aug	1	,, Profit and Loss on Cancellation of Debentures Account		10
		,, Profit and Loss on Cancellation of Debentures Account	15		1,000					
	31	,, Balance		c/d	5,000					
					£10,010					£10,010
						19				
						Jan	1	By Balance	b/d	5,000

Dr PROFIT AND LOSS ON CANCELLATION OF DEBENTURES *Cr*

Date		Particulars		£	s	d	Date		Particulars		£	s	d
19							19						
Aug	1	To Debentures Account		10	0	0	Aug	1	By Debenture Interest Account		20	0	0
		,, Balance	c/d	10	0	0							
				£20	0	0					£20	0	0
Dec	31	To Debenture Interest Account		2	10	0	Aug	1	By Balance	b/d	10	0	0
		,, Balance	c/d	22	10	0	Dec	15	,, Debentures Account		15	0	0
				£25	0	0					£25	0	0
							19						
							Jan	1	By Balance	b/d	22	10	0

Dr DEBENTURE INTEREST *Cr*

Date		Particulars		£	s	d	Date		Particulars		£	s	d
19							19						
Aug	1	To Profit and Loss on Cancellation of Debentures Account[1]		20	0	0	Dec	31	By Profit and Loss on Cancellation of Debentures Account		2	10	0
Dec	31	,, Debenture holders (Interest) Account		180	0	0			,, Profit and Loss Account		197	10	0
				£200	0	0					£200	0	0

[1] One month's interest on £4,000 at 6 per cent per annum

Dr. DEBENTURE-HOLDERS (INTEREST) **Cr.**

		£			£
19.. Dec. 31	To Cash . . .	99	19.. Dec. 31	By Debenture Interest Account[1] . . [£6,000 at 6% per annum for six months]	180
	,, Income Tax (at 9s. in the £) .	81			
		£180			£180

The respective profits on cancellation may be proved as follows—

(1) 1st August cancellation. The price at *true* par, i.e. principal plus interest to date should be $100 + \frac{1}{2}$ per cent [i.e. 6 per cent per annum for 1 month] $= 100\frac{1}{2}$. This burden is discharged at $100\frac{1}{4}$, leaving a profit of $\frac{1}{4}$ per cent on £4,000 = £10, which is the balance shown in the account.

(2) 15th December cancellation. The "cum interest" price at this date should be —

$100 + 5\frac{1}{2}$ months' interest at 6 per cent per annum $= 102\frac{3}{4}\%$.

But seeing that the price is to be reckoned "ex interest," 6 months interest must be deducted, viz. 3%—

True "par" value [$102\frac{3}{4}\% - 3\%$]	=	$99\frac{3}{4}\%$
The purchase price	=	$98\frac{1}{2}\%$
Leaving a profit of	=	$1\frac{1}{4}\%$

Hence $\frac{1\frac{1}{4}}{100} \times$ £1,000 = £12 10s. profit over par value is made by the company.

In order, therefore, to adjust capital and income, a debit to capital and a credit to interest of £2 10s. is required, bringing the true cost of purchased debentures to $99\frac{3}{4}$. This reduces the redemption profit to £12 10s. In other words, $99\frac{3}{4}$ "ex interest" is the actual "no profit no loss" price, but the actual price being $98\frac{1}{2}$ there is clearly a gain of $1\frac{1}{4}$ per cent on £1,000.

It must be noted that the interest on 31st December is upon £6,000, that is, the remaining debentures plus those redeemed "ex interest" because the debenture-holders are on the register at the time of the sale "ex interest," and are thus entitled to the interest.

The net charge to Profit and Loss for the half-year ended 31st December is computed as follows—

	£	s.	d.
1 month's interest on £4,000 at 6% per annum.	20	0	0
$5\frac{1}{2}$ months' interest on £1,000 at 6% per annum	27	10	0
6 months' interest on £5,000 at 6% per annum. [on debentures still outstanding]	150	0	0
[See page 856]	£197	10	0

General Illustration. A company raises a loan of £20,000 upon debenture stock at a discount of 10 per cent on 1st January, 1951. The loan is redeemable at par at the end of a period of years by a Cumulative Sinking Fund, but the company has power to call upon

[1] Alternatively, the net amount of £99 might be credited to this account and Tax debited to Debenture Interest Account.

the trustees to apply the Sinking Fund investments in the purchase of stock, *if below par*, at any time. The annual Sinking Fund contribution, exclusive of interest accumulated, is £2,000. This amount is promptly invested, together with income accumulations, on 1st January in each year; capital balances arising from realization of investments are reinvested at the same time. The Sinking Fund instalments are calculated on a 3 per cent basis, but are invested to give a higher yield.

Sinking Fund investments produce interest, less tax, as follows: 1952, £86; 1953, £139.

Realizations of Sinking Fund investments are as follows—

1st Oct., 1952,	£1,014;	original cost, £1,000.
1st July, 1953,	£373;	original cost, £400.

The proceeds of realizations are applied in redemption of stock as follows—

1st Oct., 1952,	£960;	in cancellation of £1,000 Stock.
1st July, 1953,	£383;	in cancellation of £400 Stock.

Ignore interest on debenture stock.

Prepare accounts in respect of the Sinking Fund transactions given for the years 1951 to 1953 inclusive, showing the manner in which the Sinking Fund would be compensated for the loss of interest resulting from the realization of investments. State also how you would deal with the accounts relating to discount on issue, profit on cancellation of stock, and profit and loss on realization of investments.

[For sake of completeness a Cash Account and Profit and Loss Appropriation Account in relation to the whole set of transactions is given, together with a "Trial Balance."]

Dr. CASH (*re* DEBENTURE STOCK) *Cr.*

			£				£
1951 *Jan. 1*	To *Debenture Stock Account* . .		*18,000*	1951 Dec. 31	By Balance . .	c/d	18,000
1952 Jan. 1	To Balance . .	b/d	18,000	1952 Jan. 1	By Sinking Fund Investments Account		2,000
Oct. 1	,, Sinking Fund Investments Account . .		1,014	Oct. 1	,, Debenture Stock Account . .		960
Dec. 31	,, Sinking Fund Account—Interest .		86	Dec. 31	,, Deposit Account .		54
					,, Balance . .	c/d	16,086
			£19,100				£19,100
1953 Jan. 1	To Balance . .	b/d	16,086	1953 Jan. 1	By Sinking Fund Investments Account		2,000
July 1	,, Sinking Fund Investments Account		373		,, ,, ,, .		86
	,, Suspense Account .		10	July 1	,, Debenture Stock Account . .		383
Dec. 31	,, Sinking Fund Account—Interest .		139	Dec. 31	,, Balance . .	c/d	14,139
			£16,608				£16,608
1954 Jan. 1	To Balance . .	b/d	14,139				

Dr. DEPOSIT ACCOUNT Cr.

1952 Dec 31	To Cash		£ 54	1953 Jan. 1	By Sinking Fund Investments Account		£ 54

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT Cr.

			£				
1951 Dec. 31	To Sinking Fund Account		2,000				
1952 Dec. 31	„ Sinking Fund Account		2,000				
1953 Dec. 31	„ Sinking Fund Account		2,000				

Dr. DEBENTURE STOCK Cr.

			£				£
1952 Oct. 1	To Cash		960	*1951 Jan. 1*	By *Sundries*		*20,000*
	„ Profit and Loss on Cancellation of Debenture Stock Account		40				
Dec. 31	„ Balance	c/d	19,000				
			£20,000				£20,000
1953 July 1	To Cash		383	1953 Jan. 1	By Balance	b/d	19,000
	„ Profit and Loss on Cancellation of Debenture Stock Account		17				
Dec. 31	„ Balance	c/d	18,600				
			£19,000				£19,000
				1954 Jan. 1	By Balance	b/d	18,600

Dr. SINKING FUND INVESTMENTS Cr.

			£				£
1952 Jan. 1	To Cash		2,000	1952 Oct. 1	By Cash		1,014
Oct. 1	„ Profit and Loss on realization of Investments Account		14	Dec. 31	„ Balance	c/d	1,000
			£2,014				£2,014
1953 Jan. 1	To Balance	b/d	1,000	1953 July 1	By Cash		373
	„ Cash invested— Amount annually set aside £2,000 Interest on Investments 86 Balance of sale of Investments 54		2,140		„ Profit and Loss on realization of Investments Account		27
				Dec. 31	„ Balance	c/d	2,740
			£3,140				£3,140
1954 Jan. 1	To Balance	b/d	2,740				

Dr. SUSPENSE (*re* CASH) **Cr.**

			£				£
				1953 July 1	By Cash . . .		10

Dr. SINKING FUND **Cr.**

			£				£
1952 Dec 31	To General Reserve .		1,000	1951 Dec. 31	By Profit and Loss Appropriation Account. . .		2,000
	,, Balance . .	c/d	3,140	1952 Oct. 1	,, Profit and Loss on Cancellation of Debenture Stock Account. . .		40
					,, Profit and Loss on realization of Investments Account		14
				Dec 31	,, Interest on Investments Account .		86
					,, Profit and Loss Appropriation Account. . .		2,000
			£4,140				£4,140
1953 July 1	To Profit and Loss on realization of Investments Account		27	1953 Jan. 1	By Balance . .	b/d	3,140
Dec. 31	,, General Reserve .		400	July 1	,, Profit and Loss on Cancellation of Debenture Stock Account. . .		17
	,, Balance . .	c/d	4,869	Dec. 31	,, Interest on Investments Account .		139
					,, Profit and Loss Appropriation Account. . .		2,000
			£5,296				£5,296
				1954 Jan. 1	By Balance . .	b/d	4,869

Dr. PROFIT AND LOSS ON CANCELLATION OF DEBENTURE STOCK **Cr.**

			£				£
1952 Oct. 1	To Sinking Fund Account . .		40	1952 Oct. 1	By Debenture Stock Account . .		40
1953 July 1	To Sinking Fund Account . .		17	1953 July 1	By Debenture Stock Account . .		17

Dr. PROFIT AND LOSS ON REALIZATION OF INVESTMENTS **Cr.**

			£				£
1952 Oct. 1	To Sinking Fund Account. . .		14	1952 Oct. 1	By Sinking Fund Investments Account		14
1953 July 1	To Sinking Fund Investments Account		27	1953 July 1	By Sinking Fund Account. . .		27

Dr. GENERAL RESERVE *Cr.*

1952 Dec. 31	To Discount on Debenture Stock Account . .		£ 1,000	1952 Dec 31	By Sinking Fund Account. . .		£ 1,000
1953 Dec. 31	To Discount on Debenture Stock Account . .		400	1953 Dec. 31	By Sinking Fund Account. . .		400

Dr. DISCOUNT ON DEBENTURE STOCK *Cr.*

1951 Jan. 1	*To Debenture Stock Account . . .*		£ *2,000*	1952 Dec. 31	By General Reserve .		£ 1,000
					,, Balance . .	c/d	1,000
			£2,000				£2,000
1953 Jan. 1	To Balance . .	b/d	1,000	1953 Dec. 31	By General Reserve .		400
					,, Balance . .	c/d	600
			£1,000				£1,000
1954 Jan. 1	To Balance . .	b/d	600				

Opening items are in italics.

TRIAL BALANCES

		31st Dec., 1952		31st Dec., 1953		
		Dr.	*Cr.*		*Dr.*	*Cr.*
		£	£		£	£
Debenture Stock . .			19,000			18,600
Sinking Fund . . .			3,140			4,869
Sinking Fund Investments		(a) 1,000			(a)2,740	
Cash: General (x)	£16,000			(y)£14,000		
,, Interest (b)	86			(b) 139		
Deposit . (c)	54				14,139	
		16,140				
Suspense						(c)[1] 10
Discount on Debenture Stock		1,000			600	
Profit and Loss Appropriation		4,000			6,000	
		£22,140	£22,140		£23,479	£23,479

[1] This is shown in a separate account for clearness and signifies that £10 of General Cash has been used in redeeming the Debenture Stock. On reference to the Cash Account it will be seen that £373 was received from the sale of Investments and £383 used to repay the Debenture Stock.

NOTES on 31st December, 1952, Trial Balance.

(1) The sum of (*a*) (*b*) and (*c*) together with £2,000 to be invested on 1st Jan., 1953, will equal the balance of Sinking Fund Account.

(*x*) This is £18,000 less £2,000 invested in Sinking Fund Investment Account.

NOTES on 31st December, 1953, Trial Balance.

(1) The sum of (*a*) and (*b*) less (*c*) together with £2,000 to be invested on 1st Jan., 1954, will equal the balance of Sinking Fund Account.

(*y*) This is £16,000 less £2,000 invested in Sinking Fund Investment Account.

NOTES. (i) As the Sinking Fund is used to cancel the Debenture Stock a proportion of the former is now "free," and, subject to the desirability of eliminating part of the Debenture Discount, becomes a general reserve.

(ii) Compensation to the Sinking Fund in respect of loss of interest on investments sold is unnecessary since debentures have been cancelled by the proceeds of sale of Investments and so the charge for Debenture Interest diminished, but the Sinking Fund should be reconstituted so as to provide for redemption of the remaining debentures at the expiry of the period of ten years from 1st January, 1951.

Conversion into New Debentures. When a company has power to redeem debentures, advantage of low interest rates will usually be taken to replace the old debentures yielding a high interest by a new issue carrying a lower rate.

The book-keeping entries are merely the entries appertaining to (*a*) the redemption of debentures followed by those appertaining to (*b*) the issue of debentures.

Conversion of Debentures into Shares. It will be remembered that debentures may be issued at a discount, whilst shares cannot, except as provided by Sect. 57 of the Companies Act, 1948. The Courts will not permit the evasion of the latter restriction by the device of an issue of debentures at a discount and their conversion into the equivalent *number* of *fully* paid shares, but it is permissible to make the conversion as indicated if the debentures have become *bona fide* redeemable, there being no necessity for a formal repayment to the debenture-holders with an immediate return of the money by them to acquire shares.

It is quite legal, however, even when the debentures have not become repayable, to convert into the same number of shares (representing the nominal value of the debentures) if they are partly paid to the extent of the cash originally paid for the debentures, or even into fully paid shares on a basis that their number is in the same proportion that the cash paid on the original debentures bore to their nominal value.

Illustration. A company issued £10,000 debentures at 95. On what basis can they be converted into shares?

1. If they have become (*bona fide*) due for repayment, 10,000 shares of £1 each fully paid may be issued in exchange.

2. Otherwise, 9,500 shares of £1 each fully paid (i.e. 19 shares of £1 each fully paid for £20 debentures) or 10,000 shares of £1 each, 19s. paid (i.e. one share of £1 each, 19s. paid for every £1 debenture) may be issued in exchange.

The same principles will apply where power is given to the debenture-holder to require his debenture to be converted into shares.

Any "profit" on conversion of debentures into shares should be credited to Share Premium Account or utilized to write off the debenture discount outstanding.

Examination Problem. The terms of an issue of 100,000 5 per cent debentures of £1 each included the following—

1. Interest payable half-yearly, 31st March and 30th September.
2. Twenty-five per cent of the profits of any year are to be applied in redeeming debentures and, upon being redeemed, they are to be cancelled.
3. The company may purchase its debentures in the open market without limitation to the amount redeemable as above; those to be redeemed, if not obtainable by purchase, being drawn by lot and surrendered at 20s. 6d.
4. Any debentures purchased in excess of the obligatory amount may, entirely at the option of the company, be cancelled or kept alive for reissue.
5. Upon giving three months' notice the company can redeem the debentures outstanding at 22s.

On 1st October, 1952—

1. £48,200 debentures had been redeemed and cancelled.
2. The profits for the year to date are £42,000.
3. The company held £28,200 of its live debentures (cost £25,380).

On the above date the debentures to be redeemed and cancelled were appropriated out of the company's holding, and three months' notice to redeem the ["outside"] debentures was given.

The redemption was duly completed on 1st January, 1953, and the interest for the three months duly paid.

On 31st March, 1953, following, it was resolved that the remaining debentures should be cancelled.

Show Ledger Accounts, ignoring income tax.

(*Institute of Chartered Accountants, Final.*)

The student as a rule finds a difficulty in presenting a reasonably good answer to this type of question because the terms indicated are not clearly grasped. What the terms really amount to are that a certain *minimum* number must be redeemed and cancelled yearly. This minimum is to be equal to 25 per cent of the profits in any one year, but the company *may* purchase as many as it thinks fit; and similarly may use those debentures in part or whole discharge of its obligatory minimum. As for the remainder of the debentures so purchased, the company may keep them alive for reissue. If the company has not bought sufficient of its own debentures to pay off the minimum, then it must draw lots as to the balance and pay off these debentures at 20s. 6d. Quite apart from the above, the company can always, if it so desires, give due notice to the debenture-holders and redeem with interest at 22s.

Dr. **Debentures** Cr.

Date	Particulars		£	Date	Particulars		£
1952 Oct. 1	To Own Debentures Purchased Account		10,500	1952 Oct. 1	By Balance	b/d	51,800
1953 Jan. 1	,, Cash		25,960	1953 Jan. 1	,, Premium on Redemption of Debentures Account		2,360
April 1	,, Own Debentures Purchased Account		17,700				
			£54,160				£54,160

Dr. **Debenture Redemption Fund** Cr.

Date	Particulars		£	Date	Particulars		£
1953 April 1	To General Reserve		10,500	1952 Oct. 1	By Profit and Loss Appropriation Account[1]		10,500

Dr. **Own Debentures Purchased** Cr.

Date	Particulars		Nominal £	£	Date	Particulars		Nominal £	£
1952 Oct. 1	To Balance	b/d	28,200	25,380	1952 Oct. 1	By Debentures Account		10,500	10,500
	,, Profit on Redemption of Debentures Account			1,050	1953 Apr. 1	,, Do.		17,700	17,700
1953 Apr. 1	,, Do.			1,770					
			£28,200	£28,200				£28,200	£28,200

Dr. **Profit on Redemption of Debentures** Cr.

Date	Particulars		£	Date	Particulars		£
1953 Jan. 1	To Premium on Redemption of Debentures Account		2,360	1952 Oct. 1	By Own Debentures Purchased Account		1,050
April 1	,, General Reserve		460	1953 April 1	,, Do.		1,770
			£2,820				£2,820

Dr. **Debenture Interest** Cr.

Date	Particulars		£	s.	d.	Date	Particulars		£	s.	d.
1953 Jan. 1	To Debenture-holders Account		516	5	0	1953 Jan. 1	By Debenture-holders Account (own debentures)		221	5	0
April 1	,, Do.		221	5	0	April 1	,, Do. Do.		221	5	0
							,, Profit and Loss Account		295	0	0
			£737	10	0				£737	10	0

[1] I.e. 25 per cent of £42,000 = £10,500.

Dr. PREMIUM ON REDEMPTION OF DEBENTURE *Cr.*

1953 Jan. 1	To Debenture Account: Premium on Redemption .		£ 2,360	1953 Jan. 1	By Profit on Redemption of Debentures Account .		£ 2,360

Dr. GENERAL RESERVE *Cr.*

1953 April 1	To Balance . .	c/d	£ 10,960	1953 April 1	By Debenture Redemption Fund Account		£ 10,500
					,, Profit on Redemption of Debentures Account . .		460
			£10,960				£10,960
				April 2	By Balance . .	b/d	10,960

The first transaction is the cancellation of debentures out of those purchased, which reduces the debentures to £41,300 and the investment to £17,700. The second transaction is the redemption by notice at 22s. of all the debentures outstanding, viz. £23,600, made up as follows—

		£
Balance [as above]		41,300
Less Debentures in hands of the Company . .	£28,200	
Less Cancelled	10,500	
		17,700
Balance still "out"		£23,600

On 1st January, 1953, interest (after taking into account the debentures held by the company as an investment) is 5 per cent on £23,600 for a quarter year, viz. £295. The Debenture Interest Account should show both the interest payable and the interest receivable, but the cash *payments* can only be to the holders of £23,600—the "outsiders." The Journal form of entry would be—

		£	s.	d.	£	s.	d.
Debenture Interest (*a*)	*Dr.*	516	5	0			
To Debenture Interest (*b*)					221	5	0
Cash					295	0	0

(*a*) Interest at 5% per annum for quarter year on £41,300 = £516 5s. 0d.
(*b*) Interest at 5% per annum for quarter year on £17,700 = £221 5s. 0d.

On 1st Jan., 1953, all the "outside" debentures have been paid off and therefore the balance of debentures as a liability must be equalled by the balance of debentures held by the company as an investment, viz. £17,700 nominal; the interest receivable on which will cancel the interest payable, i.e. £221 5s.

As the debentures were purchased at the price of 18s. (£28,200 at 18s. = £25,380) and as all the debentures purchased are used to extinguish the debentures as a liability at *par*, there must be a profit of £2,820 (£28,200 at 2s.) as shown by Profit on Redemption

of Debentures Account. The ultimate profit, after debiting the loss on redemption, is £460, which is transferred, together with the balance of the redemption fund, to general reserve.

Although it is in this instance not called for, the student should note that the debentures held as an investment might be treated as the Redemption Fund investment, the interest on which will be debited to the former and credited to the Redemption Fund.

The final profit is readily proved as follows—

The cost to redeem £51,800 debentures is—

	Nominal	*Cost*
	£	£
(*a*)	28,200 at 18s.	25,380 (*ex* Debentures purchased)
(*b*)	23,600 at 22s.	25,960 (*ex* Cash)
	£51,800	51,340
	leaving a profit of	460
	Total	£51,800

The entries for the redemption would be as shown in the Ledger, or as below—

JOURNAL

			£	£
1953 Jan. 1	Debentures . . . . . *Dr.*		23,600	
	Premium on Redemption of Debentures . . . . *Dr.*		2,360	
	To Cash			25,960
	Being redemption of £23,600 Debentures at 22s. each by three months' notice, in accordance with the terms of the Debenture Deed as per Directors' resolution dated ..... *vide* Minute Book, p.			

The proviso as to drawings by lot does not operate because there is an adequate "supply" of debentures purchased, i.e. £28,200 to redeem £10,500; it is only in the event of this "supply" being less than the latter figure that the above term in the debenture deed becomes applicable.

Illustration. Aldley & Co. has issued Share Capital of 100,000 Ordinary Shares of £1 each fully paid and 100,000 5 per cent Preference Shares of £1 each fully paid. The company has £150,000 4½ per cent Debenture Stock, now redeemable at 25 per cent premium.

In order to provide funds for the redemption of the Debenture Stock the company issued a further 100,000 Ordinary Shares and a further 100,000 5 per cent Preference Shares at a premium of 2s 6d. and 5s. each respectively, all of which were paid up in full. No Sinking Fund existed.

Show the Balance Sheet, immediately after the completion of the above arrangements, in so far as the facts given permit.

BALANCE SHEET (includes)

		£		£
Share Capital: Issued and fully paid—			Cash	50,000
200,000 5% Preference Shares of £1 each		200,000		
200,000 Ordinary Shares of £1 each		200,000		
Share Premium Account—				
Ordinary Shares	£12,500			
5% Preference Shares	25,000			
	37,500			
Less Transfer to Debenture Stock	37,500	—		
		400,000		
4½ per cent Debenture Stock	£150,000			
Add Premium	37,500			
	187,500			
Less Cash	187,000	—		

[*Note*. The Cash received is (*a*) Ordinary Shares, £112,500; (*b*) Preference Shares, £125,000; Cash paid to redeem Debenture Stock, £187,500, giving a balance of £50,000.]

Mine Redemption Funds. In accounts of concerns such as mines holding wasting assets, provision may be made against the depletion of the assets by charging up so much per ton mined as depreciation. Provision may similarly be made for redeeming debentures.

It must be appreciated that while the first provision is a charge against profits in respect of depletion, the second is merely an appropriation of profits to provide funds for the repayment of a liability.

Illustration. The X Tin Mining Co., Ltd., with debenture stock £20,000, sets aside 1s. per ton mined to cover depletion of assets and provision for redemption of debentures, the sum being apportioned in the ratio 3 : 1 to the respective objects.

The number of tons raised in the year ended 31st December, 19.., was 200,000. Total sales, £220,000. Total expenses, £180,000. Show Profit and Loss Account for year ended 31st December, 19...

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DEC., 19..

Dr.		£			*Cr.* £
To Expenses		180,000	By Sales		220,000
,, Depreciation—Depletion Account		7,500			
,, Balance, being net profit for year	c/d	32,500			
		£220,000			£220,000
To Debenture Redemption Fund		2,500	By Balance	b/d	32,500
,, Balance	c/d	30,000			
		£32,500			£32,500
			By Balance	b/d	30,000

SECTION (E) ALTERATIONS OF SHARE CAPITAL

The alterations of share capital comprise the following—

(1) Increase or decrease of authorized capital.

(2) Conversion of fully-paid shares into stock and stock into shares.
(3) Subdivision of shares.
(4) Consolidation of shares.
(5) Redemption of redeemable preference shares.
(6) Reduction of share capital.
(7) Reorganization of share capital.
(8) Bonus share issue.

(1) **Increase or Decrease in Authorized Capital.** Where a company desires to issue additional shares, it must pay the 10s. per cent[1] capital duty on the increase, where necessary, of the authorized capital, e.g. if the present authorized capital is £5,000 and the issued share capital is £4,000, the company may issue a further £1,000 without incurring a further charge. But if it wishes to issue, say, a further 6,000 shares, the authorized capital must be increased to £10,000, and stamp duty on the additional £5,000 will be incurred.

On the other hand, if a company finds that its authorized capital is in excess of all possible requirements, it may decrease it, but no good purpose is served thereby, as there is no repayment of capital duty on a decrease. There are no book-keeping entries involved.

A company may increase or decrease its authorized capital as it wishes, according to its Articles; but if Table A is adopted, the necessary authority is an ORDINARY Resolution. The student must not confuse a reduction of *authorized* capital with reduction of *issued* capital, which is dealt with on page 873.

(2) **Conversion of Fully-paid Shares into Stock and Stock into Shares.** Stock is the consolidation of the share capital into one unit divisible into aliquot parts. Whilst it is impossible to transfer less than one share, any amount of stock may be transferred, although in practice companies may restrict the transfers of stock to multiples of say £10. The transfer of stock avoids dealing with the distinctive numbers required in share transfers, and thus saves considerable clerical work (see page 830).

In recent years a practice has been established whereby stock is transferable in £ units, e.g. £100 stock may be transferable in the form of 100 units, so that a buyer of 50 units is buying the equivalent of £50 of stock or 50 £1 shares fully paid.[2]

A company must first issue fully-paid shares and then proceed to make the conversion, an *original* issue of stock not being permissible, subject to the proviso that it must follow its own articles regulating the resolution required; and if Table A is adopted, it is necessary to obtain the consent of the company in general meeting. Every copy of the Memorandum and Articles of Association must thereafter have such alterations incorporated therein.

The book-keeping entries merely record the transfer from Share

[1] In certain circumstances relief is granted in respect of stamp duty on increase of authorized capital (see Section I).
[2] But see page 831.

Capital Account to Stock Account, but a Stock Register will be opened to contain the statutory details of members' holdings, and the Annual Return modified accordingly.

Illustration. Y, Ltd., after passing the necessary resolution, converts its 20,000 ordinary shares of £1 each fully paid into £20,000 ordinary stock. Show Journal entry.

JOURNAL

			£	£
	Ordinary Share Capital . . . . *Dr.*		20,000	
	To Ordinary Stock			20,000
	Being the conversion of 20,000 ordinary shares of £1 each fully-paid into £20,000 ordinary stock per resolution (described) dated .... *vide* Minute Book, p.			

If the company's articles require the passing of a special resolution, a *printed* copy thereof must be filed with the Registrar of Companies within fifteen days, except in the case of an exempt private company when the copy may be in some other form approved by the Registrar. (Companies Act, 1948, Sect. 143 (1).)

Illustration. Y, Ltd., after passing the necessary resolution, converts its 20,000 ordinary shares of £1 each fully paid into £19,000 ordinary stock on the basis of £95 of stock for every 100 fully-paid shares of £1 each.[1] Show Journal entry.

JOURNAL

			£	£
	Ordinary Share Capital . . . . *Dr.*		20,000	
	To Ordinary Stock			19,000
	,, Premium on Stock			1,000
	Being the conversion of 20,000 fully-paid ordinary shares of £1 each into £19,000 stock at the rate of £95 per 100 shares per resolution (described) dated......... and sanction of the Court dated .... *vide* Minute Book, p.			

Illustration. Y, Ltd., after passing the necessary resolution, converts its 20,000 ordinary shares of £1 each fully paid into £21,000 ordinary stock on the basis of £105 of stock for every 100 fully-paid shares of £1 each.[1] Show Journal entry.

JOURNAL

			£	£
	Ordinary Share Capital . . . . *Dr.*		20,000	
	Discount on Stock . . . . . *Dr.*		1,000	
	To Ordinary Stock			21,000
	Being the conversion of 20,000 fully-paid ordinary shares of £1 each into £21,000 stock at the rate of £105 per 100 shares per resolution and sanction as above.			

[1] Tantamount respectively to a reduction of capital and an issue at a discount, so the procedure required therefor must be followed. (See pp. 814 and 873).

Converse entries will be required for reconverting stock into shares.

(3) **Subdivision of Shares.** A company may find that, owing to the high nominal value of its shares, dealings in the shares are impeded and, in consequence, desires to subdivide them into shares with a smaller nominal value.

The members are entitled to have a proportionately larger number of shares of the smaller denomination in exchange for the shares of the higher, e.g. if a share is of a £10 denomination the holder is entitled to receive, say, 10 shares of £1 each, or 100 shares of 2s., paid up proportionately. If the £10 share mentioned is fully paid, so must be the subdivided shares; if partly paid, the subdivided shares must be proportionately paid up, e.g. if the above shares are paid up to the extent of £7 10s., there will be 15s. and 1s. 6d. paid up on a £1 share and a 2s. share respectively.

Subdivision must be authorized by the Articles, otherwise a special resolution will be necessary to *create* such power. When authority is obtained, an ORDINARY resolution suffices to *exercise* the power as it does if Table A is adopted.

The book-keeping entry involves merely a transfer from the original to the revised share capital account—the totals being unaltered.

Illustration. A company with a share capital of 20,000 ordinary shares of £1 each fully paid carries out by proper resolution a subdivision into shares of 5s. each fully paid. Show Journal entry.

JOURNAL

			£	£
	Ordinary Share Capital (£1) . . *Dr.*		20,000	
	To Ordinary Share Capital (5s.) . .			20,000
	Being the subdivision of 20,000 fully-paid ordinary shares of £1 each into 80,000 shares of 5s. each fully paid per resolution (described) dated ...... *vide* Minute Book, p.			

Each member will receive four fully-paid new shares for every one old share.

If the shares to be subdivided had been 40,000 shares of £1 each, 10s. paid, the holders would receive 160,000 shares of 5s. each, 2s. 6d. paid, involving the same Journal entry so far as relates to the money column, the narrative being adjusted accordingly.

It will be necessary to prepare a subdivision list, so as to facilitate the work involved in making the exchange to each member.

The Annual Return, Register of Members, and the description of the shares in the Balance Sheet will be altered accordingly.

(4) **Consolidation of Shares.** The book-keeping entries are the reverse of those in the preceding paragraph. The authority required is an ordinary resolution, if Table A is adopted.

(5) **Redemption of Preference Share Capital.** The following are the provisions relating to the issue and redemption of Redeemable Preference Shares contained in Sect. 58 of the Companies Act, 1948.

(*a*) A company may issue redeemable preference shares provided that no such shares shall be redeemed except out of *profits* of the company which would otherwise be available for dividend; or out of the *proceeds* of a fresh issue of shares made for the purposes of the redemption.

(*b*) No such shares shall be redeemed unless *fully* paid.

(*c*) The issue must be authorized by the Articles.

(*d*) Where any such shares are redeemed otherwise than out of the proceeds of a fresh issue, there shall be transferred out of profits which would otherwise have been available for dividend, to a reserve fund, to be called "THE CAPITAL REDEMPTION RESERVE FUND," a sum equal to the nominal amount of the shares redeemed.

(*e*) The redemption is not to be regarded as a reduction of the authorized share capital of a company.

(*f*) The Capital Redemption Reserve may be used wholly or in part in paying up unissued shares of the company to be issued as Bonus Shares; but otherwise the provisions of the Act relating to reduction of share capital apply as if it were paid up share capital of the company.

(*g*) Every Balance Sheet must include a statement specifying what part of the issued capital of the company consists of such shares and the earliest date on which the company can redeem the shares.

(*h*) The premium, if any, payable on redemption must have been provided out of the profits of the company or out of the company's share premium account before the shares are redeemed.

Notice to Registrar. If a company having a share capital has—

(*a*) Consolidated and divided its share capital into shares of larger amount than its existing shares; or

(*b*) converted any of its shares into stock; or

(*c*) re-converted stock into shares; or

(*d*) subdivided its shares or any of them; or

(*e*) redeemed any redeemable preference shares; or

(*f*) cancelled any shares (otherwise than in connection with a reduction of capital),

it shall within *one month* after so doing give notice thereof to the Registrar of Companies, specifying, as the case may be, the shares consolidated, divided, converted, subdivided, redeemed, or cancelled, or the stock re-converted. (Sect. 62.)

Illustration. 10,000 six per cent Redeemable Preference Shares of £1 each fully paid in A, Ltd., are outstanding on 1st Jan., 19... This being the date of redemption, the shares are redeemed at 22s. each. 4,000 Ordinary Shares of £1 each are issued at 21s. for cash for the purpose of redemption. Show Ledger entries, assuming that the balance of Profit and Loss Appropriation Account is £24,600.

Dr. 6% REDEEMABLE PREFERENCE SHARES **Cr.**

19 Jan. 1	To Sundry Members .		£ 10,000	19 . Jan 1	By Balance . .	b/d	£ 10,003

Dr. SUNDRY MEMBERS **Cr.**

19 . Jan. 1	To Cash . .		£ 11,000	19 . Jan 1	By 6% Redeemable Preference Shares Account . .		£ 10,000
					,, Premium on Redemption of Shares Account .		1,000
			£11,000				£11,000

Dr. PREMIUM ON REDEMPTION OF SHARES **Cr.**

19 . Jan. 1	To Sundry Members		£ 1,000	19 Jan 1	By Profit and Loss Appropriation Account		£ 1,000

Dr. ORDINARY SHARE CAPITAL **Cr.**

				19 Jan 1	By Cash . .		£ 4,000

Dr. SHARE PREMIUM **Cr.**

				19 . Jan 1	By Cash[1] . .		£ 200

Dr. PROFIT AND LOSS APPROPRIATION **Cr.**

19 . Jan. 1	To Premium on Redemption of Preference Shares		£ 1,000	19 Jan 1	By Balance .	b/d	£ 24,600
	,, Capital Redemption Reserve Fund		6,000				
	,, Balance .	c/d	17,600				
			£24,600				£24,600
				Jan 2	By Balance . .	b/d	17,600

Dr. CAPITAL REDEMPTION RESERVE FUND **Cr.**

				19 . Jan. 1	By Profit and Loss Appropriation Account		£ 6,000

[1] This may be used towards payment of the premium on redemption, in which case the debit to Profit and Loss Appropriation Account for that item will be £800 instead of £1,000.

(6) **Reduction of Capital.** By Section 66 of the Companies Act, 1948, a company may reduce its capital IN ANY WAY, provided it is authorized in its ARTICLES and in particular—

(*a*) Extinguish or reduce the LIABILITY on any of its shares in respect of capital not paid up, e.g. £1 share, 5s. paid, may be changed into a 5s. fully-paid share (*extinguishing* the liability entirely) or a 7s. 6d. share, 5s. paid (*reducing* the liability by 12s. 6d.).

(*b*) Cancel any paid-up capital which is LOST or unrepresented by available assets—either *with or without* extinguishing or reducing the liability on any of its shares.

(*c*) Pay off any share capital in EXCESS of the requirements of the company either *with or without* extinguishing or reducing the liability on any of its shares, e.g. where a £1 share fully paid is repaid 8s., leaving a £1 share 12s. paid or a 12s. share fully paid.

If the authority required under this section is not contained in the Articles (NOT Memorandum), the company must by special resolution supply such omission in the Articles; after which the scheme must be carried out, in any case, by a special resolution. Where necessary, the two resolutions may be validly passed at one meeting of members.

The proposed scheme must be submitted to the Court for its approval, failure to obtain which renders it ineffective.

The Court may require the addition of the words "and reduced" after the company's name, but this formality is not required unless the Court so orders.

The resolution for the reduction of share capital will not take effect until there has been filed with the Registrar of Companies—

(1) A copy of the order of the Court sanctioning the scheme.

(2) A minute, approved by the Court, showing with respect to the share capital of the company as altered by the order, the amount of the share capital, the number of shares into which it is to be divided and the amount of each share, and the amount, if any, at the date of registration deemed to be paid up on each share.

The certificate of the Registrar that the order and minute have been registered is conclusive evidence that all the provisions of the Act have been complied with.

The entries in respect of extinguishing or reducing uncalled capital merely involve a transfer similar to subdivision, viz. from the "old" to the "new." The Annual Return, Register of Members, and Balance Sheet as affected by the reduction of share capital will require suitable amendment.

Illustration. X, Ltd., has an issued share capital of 10,000 shares of £1 each, 5s. paid, and having complied with all legal formalities, proceeds to extinguish the uncalled liability on its shares. Show Journal entry.

JOURNAL

			£	£
	Ordinary Share Capital (£1) . . *Dr.*		2,500	
	To Ordinary Share Capital (5s.) . .			2,500
	Being the extinguishing of the uncalled liability of 15s. on shares per special resolution dated........ Court order dated........ *vide* Minute Book, page			

Upon the ascertainment of the loss on the assets and/or the addition to liabilities, the method of adjusting the revised state of affairs is—

(i) Debit Capital Reduction Account.
Credit Assets (in detail), including fictitious assets, e.g. debit balance of Profit and Loss Account } for writings off.
Credit Liabilities (in detail).
(ii) Debit Share Capital Account
Credit Capital Reduction Account } for reduction of Share Capital.
(iii)[1] If there is a credit balance on Capital Reduction Account—
Debit Capital Reduction Account (to close).
Credit Capital Reserve Account.

As the student will have learned, revaluations of items like debtors, investments and stock, will usually be made through the medium of a Reserve or Provision Account.

The accounting principles involved in reduction (including reorganization) of capital are of supreme importance and somewhat formidable to the student. Being, in addition, a very frequent question in the professional accountancy examinations, the subject is dealt with as exhaustively as space will permit in Section (I) of this chapter, and this paragraph is confined to the more elementary book-keeping entries.

Illustration. The Balance Sheet of Z, Ltd., is as follows—

BALANCE SHEET

	£		£
Issued Share Capital—		Sundry Assets . . .	8,000
10,000 shares of £1 each .	10,000	Debtors	1,700
Creditors	1,500	Profit and Loss Account (*Dr.*)	1,800
	£11,500		£11,500

It is decided (all formalities having been complied with) to reduce the share capital to 10,000 shares of 10s. each, fully paid; to reduce sundry assets *by* £2,500; to revalue the debtors *at* £1,000;

[1] Reverse entries would be required if the balance was debit, but this is very unlikely to happen, as the Court would not sanction a scheme of reduction in such a case.

and to eliminate the Profit and Loss Account item. Show Journal entries, ignoring narratives.

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		£	£
Capital Reduction	Dr.	5,000	
To Sundry Assets			2,500
,, Bad Debts Provision . . .			700
,, Profit and Loss Account . .			1,800
Share Capital (£1)	Dr.	10,000	
To Capital Reduction. . . .			5,000
,, Share Capital (10s.) . . .			5,000

The scheme here is simple and the eliminations are equal to the amount to be written off share capital, thus leaving no balance on Capital Reduction Account.

The Balance Sheet, after reduction, will be:

Z LTD., AND REDUCED[1]

BALANCE SHEET AS AT......

	£	£		£	£
Authorized Share Capital			Sundry Assets . .	8,000	
			Less Amount written off by Order of Court . .	2,500	
Issued Share Capital— 10,000 Shares of £1 each fully paid reduced by Order of Court to 10s each fully paid .		5,000			5,500
Creditors . . .		1,500	Debtors . . .	1,700	
			Less Bad Debt Provision to reduce value to £1,000 by Order of Court	700	
					1,000
			Profit and Loss Account. . .	1,800	
			Less written off by Order of Court .	1,800	
					—
		£6,500			£6,500

Reduction by Return of Cash to Members. Where owing to closing of departments, exhaustion of wasting assets (e.g. mines), or declining business, a company finds itself with a surplus of floating assets, it may decide to make a return of cash to members, thus reducing the share capital.

It is a frequent practice for companies to revise their assets and liabilities to current valuations at the same time as the cash representing excessive capital is repaid to members, such amendments being made through the Capital Reduction Account.

It may be noted that the latter account is often designated Reduction of Capital Account.

[1] If Court orders the addition of words "and reduced."

The book-keeping entries are—

(i) Debit Share Capital Credit Sundry Members	in respect of amount to be repaid.
(ii) Debit Sundry Members Credit Cash	upon discharge of liability.

Alternatively,

(i) Debit Share Capital (old).
Credit Sundry Members (amount to be repaid).
Credit Share Capital (new, as reduced).
(ii) As above (ii).

Illustration. W, Ltd., with a share capital of 10,000 shares of £1 each fully paid, decides to repay members 8s. in the £, the reduced share capital to be 12s. fully paid. Show Journal entry.

JOURNAL

			£	£
	Share Capital (£1) . . . . . *Dr.*		10,000	
	To Sundry Members			4,000
	,, Share Capital (12s.)			6,000
	Being reduction of 10,000 shares of £1 each fully paid to 10,000 shares of 12s. each fully paid to be discharged by a cash payment of 8s. a share per special resolution dated .... and confirmed by Court Order, dated .... *vide* Minute Book, p.			

This may be shown in two Journal entries as follows—

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			£	£
	Share Capital (Old) . . . . . *Dr.*		4,000	
	To Sundry Members			4,000
	Share Capital (Old) . . . . . *Dr*		6,000	
	To Share Capital Account (New) . .			6,000

The payment item will be posted from the Cash Book in the ordinary way, viz. debit sundry members, £4,000; and credit cash, £4,000.

The Statutory books, Annual Return and Balance Sheet will require amending accordingly.

If the shares are to remain as £1 credited as fully paid, but reduced in number, the Journal entry will be—

JOURNAL

			£	£
	Share Capital . . . . . . *Dr.*		4,000	
	To Sundry Members			4,000
	Being reduction from 10,000 shares of £1 each fully paid to 6,000 shares of £1 each fully paid, to be discharged by a cash payment of 8s. per share per special resolution dated .... and confirmed by Court Order dated .... *vide* Minute Book, p.			

Where the "security" to the creditors is likely to be impaired, e.g. by a repayment of cash, the creditors are entitled to oppose the application for Court confirmation of the proposed reduction.

(7) **Reorganization of Share Capital.** Although a reorganization may include reduction of capital, many other matters will also be involved. It is an important feature of company accounting, and special attention is given thereto in Section (I).

(8) **Bonus Shares.** See Section (H).

SECTION (F) ACQUISITION ENTRIES

Before dealing with the acquisition entries, the following general matters should be noted.

Preliminary Expenses. The term "Preliminary Expenses" embraces all expenses necessary to promote the company, of which the most important are—

(*a*) Costs attendant upon the issue of the prospectus.

(*b*) Legal, accounting, valuation, and other professional charges.

(*c*) Costs of printing the memorandum and articles, certificates, statutory books, letters of allotment and regret (usually available at law stationers in printed form), and books of account; company's seal.

(*d*) Stamp duties and registration fees.

(*e*) Underwriting and other commissions; Brokerage on applications.

Such expenses must be shown separately in the Balance Sheet till written off.

In the case of private companies, there are no expenses of issuing a prospectus.

Registration of a Company. To register a limited company, certain formalities must be complied with. Numerous documents must be filed and various stamp duties paid.

The documents to be filed with the Registrar of Companies are—

(1) Memorandum and articles of association: deed stamp, 10s. *each*; registration fee on articles, 5s.

(2) Statement of nominal capital: stamp, 10s. per cent.

(3) Notice of situation of registered office: stamp, 5s.

(4) List of directors and secretary: stamp, 5s.

(5) Consent of directors to act:[1] stamp, 5s.

(6) Contract of directors to take qualification shares in cases where they are not signatories to the memorandum:[1] stamp, 5s., together with an agreement stamp (6d.) in respect of each signature.

(7) Statutory declaration that all requirements have been complied with: stamp, 5s.

(8) Prospectus, or statement in lieu of prospectus:[1] stamp, 5s.

(9) Particulars of contract of sale: stamp, 5s.

The memorandum of association must also be impressed with a fee stamp computed according to the nominal capital, viz.—

[1] Only necessary for a public company.

	£	s.	d.
Capital not exceeding £2,000	2	0	0
Every £1,000 or part thereof (£2,000 to £5,000) .	1	0	0
Every £1,000 or part thereof (£5,000 to £100,000) .		5	0
Every £1,000 or part thereof (beyond £100,000) .		1	0

The minimum memorandum fee payable is £2 and the maximum fee £50, i.e. *ad valorem* fee on capital of £525,000.

This scale applies only to a company having share capital.

An *ad valorem* duty at the rate of £2 per cent is payable on the contract of sale in respect of—

(*a*) Equitable estates in any property.

(*b*) Patents, licences, trade-marks, and copyrights.

(*c*) Goodwill.

(*d*) Debts, including cash on Deposit Account.

(*e*) The benefit of contracts.

(*f*) Tenant's and trade fixtures and fittings which are not in a state of complete severance.

No stamp duty is payable where the property passes by mere delivery, e.g. stock-in-trade.

Where the consideration does not exceed £500 and the instrument contains a certificate to the effect that the transaction does not form part of a series in which the aggregate consideration exceeds £500, the rate of duty is 10s. per cent.

Where the consideration does not exceed £3,000, and where the consideration exceeds £3,000 but does not exceed £3,450 (accompanied by a certificate that it does not form part of a larger transaction or of a series of transactions) duty payable is reduced to the rate of £1 per cent in the former case, and, in the latter case, to the rate of £1 10s. per cent.

Where the consideration exceeds, £3,450 the duty is £1 for every £50 and fraction of £50 of the total amount.

This duty may be avoided or reduced by—

(*a*) An agreement whereby debtors are not taken over, but are collected by the purchasing company on behalf of the vendors.[1]

(*b*) An agreement whereby land and buildings are to be held in trust for the company by the vendors, no conveyance therefore being required.

(*c*) Where possible by having no written agreement of sale, the transfer of assets being effected for cash.

Underwriting Commission. Underwriting commission may be paid to any person in consideration of his subscribing or agreeing to subscribe for any share, or procuring or agreeing to procure subscriptions, whether absolute or conditional, for any shares in the company, provided that Sect. 53 of the Companies Act, 1948, is complied with, viz. the payment must be authorized by the articles,

[1] Frequently the arrangement is that neither the debtors nor creditors are taken over, but the purchasing company, as agents for the vendor, collects the debts, out of which the creditors are paid and a settlement of the balance made with the vendor.

and in no case shall the rate exceed 10 per cent of the *price* at which the shares are issued or the *amount* or *rate* authorized by the articles, whichever is the less. The amount or rate of the commission and the number of shares agreed for a commission to be subscribed must be disclosed in the prospectus or statement in lieu of prospectus duly furnished to the Registrar of Companies. The total amount paid as underwriting commission must be *separately* shown in the Balance Sheet and in the Annual Return.

By entering into arrangements with REPUTABLE underwriters, the success of an issue of shares or debentures is at the outset fully assured.

The underwriters almost invariably distribute their risk amongst others by way of sub-underwriting, the sub-underwriters not being in any contractual relationship with the company (*Collins* v. *Greyhound Racing Association*). Thus the commission is paid to the underwriters, sub-underwriters looking to the underwriters for their commission.

A special commission is sometimes paid to underwriters (in addition to the underwriting commission) for placing blocks of the underwriting with their clients. Just as the underwriting commission is paid direct to the underwriters themselves, leaving them to make their own arrangements with the sub-underwriters, so is the special commission paid direct to the underwriters. This special commission is called OVERRIDING COMMISSION.

Purchase Consideration. When an existing business is acquired by a limited company, one of the most important matters to settle is the purchase consideration. Usually a revaluation of assets and liabilities will be required, as well as an agreement upon the value of goodwill. In practice, it is usual to fix the purchase consideration in terms of a round figure, so that the goodwill item—approximating to the agreed value—will merely be a balancing figure. Occasionally the purchase consideration is accounted for by a writing up of the assets taken over in place of the introduction of a Goodwill Account, e.g. if the net assets taken over are worth £1,000 and the purchase consideration is £1,250, the balancing figure is: Goodwill, £250, unless the net assets are themselves written up to £1,250.

The principle underlying the opening entries is simple; if the purchasing company is prepared to give £100,000 for £80,000 of assets (exclusive of Goodwill) it is obvious that the Goodwill is £20,000; yet in examination work candidates frequently become confused because of the form in which the particular question is set, thus the problem being one in *ascertaining* the purchase consideration.

Suppose that a purchasing company is acquiring a business comprising Stock £5,000; Debtors £6,300; and Fixtures £3,000; against which are liabilities £7,300. The company agrees to acquire the whole business for £15,000 to be discharged as to £10,000 in Cash and £5,000 in £1 Shares at par. This question can be framed in several ways, e.g.—

(*a*) By giving details of the purchase money discharge.

In this case the sum of £15,000 represents the cost of acquiring the whole business. In order to compute the goodwill, tangible assets, separately or in total, must be given as well as the liabilities, and it is vital to know if the latter are being taken over by the purchasing company. Therefore (i) if liabilities *are* taken over, it is clear that (assuming no amendments of valuations) assets are £14,300 and liabilities £7,300, net £7,000. Hence the Goodwill is £8,000, being purchase price of £15,000 less £7,000; (ii) if liabilities are *not* taken over, the Goodwill is £700, as the purchase price is £15,000 for assets of £14,300.

(*b*) By giving the gross purchase price of the assets (stating the goodwill or the means of computing it) and giving the liabilities taken over. [If the liabilities are not taken over there is no GROSS purchase price, the figure given *is* the purchase price.] Assuming that the liabilities are taken over and the figures given in the preceding paragraphs are used, the question will be set in the form that states that the gross purchase price of the various assets is £14,300, the liabilities taken over are £7,300 and the Goodwill (either supplied or to be computed) is £8,000. From the above it is seen that the "net" tangible assets are £7,000, which together with goodwill of £8,000, equals the purchase price of £15,000.

(*c*) By giving the "net" Tangible Assets, purchase price and liabilities, the figures supplied would be £7,000, £15,000 and £7,300, from which goodwill would be deduced as £8,000. This form of presentment frequently bewilders the examination candidate, as except that it indicates what the gross tangible assets are, the item of £7,300 is superfluous, as the term "net" tangible assets means tangible assets *less* liabilities. Therefore if the "net" tangible assets of £7,000 are acquired for £15,000 the goodwill is £8,000. In order, however, to enter more fully the opening figures, the addition of the liabilities of £7,300, simply means that the tangible assets (Stock, Debtors and Fixtures) are £7,000 + £7,300, i.e. £14,300; and as the purchasing company is, in consideration for acquiring those assets of £14,300, willing to pay off liabilities £7,300 *and* give the purchase price of £15,000, it commits itself for £22,300 as against tangible assets of £14,300, thus giving £8,000 for the goodwill.

The purchase price may in fact be *less* than the net tangible assets, but the principle is the same, the balance being put to Capital Reserve or the relevant assets and/or liabilities revalued.

Goodwill. On the acquisition of a business, goodwill is frequently based upon super profits, necessitating the ascertainment of net profits and the average capital employed in the business. When these have been computed, super profits are arrived at by taking (1) Net profits, (2) less "normal risk" profits, i.e. profits reasonably expected on a business of the same NATURE and CAPITAL.

This difference represents differential or super profits, and will be capitalized by taking a number of years' purchase, considering all the circumstances, e.g.—

(1) Trend of profits in relation to CAPITAL REQUIREMENTS.

(2) Prospects—

(*a*) General all-round conditions.

(*b*) General prospects in the particular trade.

(*c*) Prospects of the particular business, especially having regard to the possibility of the company having reached "saturation" point.

(3) Status of the business.

(4) Continuity of management.

(5) Market value of shares of companies in similar occupations.

(6) Possibility of legislative or political changes (e.g. Nationalization).

(7) Valuation of assets and modernity of the equipment.

(8) Existence of favourable or unfavourable contracts, long term leases, etc.

(9) Financial structure and financial and technical efficiency.

(10) Adequacy of labour and raw materials; quota allocations, etc.

Illustration. A company's net profit is £20,000: the average capital employed is £200,000. Assuming that 8 per cent represents "normal risk" return, show the super-profit of the company.

	£
Net Profit	20,000
Less 8% of £200,000 representing "normal risk" return	16,000
Super-profit	£4,000

The capitalization is frequently graded into portions capitalized at a decreasing number of years, the first portion being capitalized at the highest as being more likely to be maintained than the next portion, each portion being less than its predecessor.

The profits brought into computation may require adjustment, e.g. the Profit and Loss Account of the vending company may have included exceptional items, e.g. a charge for rent in respect of premises which are to be acquired by the purchasing company.

Illustration. Assuming that the super-profit of a company is £7,800, each portion being taken at £2,000, the first being taken at four years' purchase, each scale to be diminished by one year's purchase, goodwill is £19,800, computed as follows—

	£
(1) First £2,000 × 4 . . .	8,000
(2) Second £2,000 × 3 . . .	6,000
(3) Third £2,000 × 2 . . .	4,000
(4) Balance £1,800 × 1 . . .	1,800
Goodwill	£19,800

Computation of Goodwill. The usual ways of computing goodwill in connection with the acquisition of a business by a limited company are—

(1) To take net profits and capitalize them for a certain number of years (varying with circumstances), and deduct therefrom the value of the net tangible assets.

(2) To take net profits and deduct therefrom the amount of net profits required to cover risk (based upon a percentage on the net assets employed), capitalizing the balance at a certain number of years' purchase.

Illustration. Assuming that the net profit of a business is £20,000 and 10 per cent is considered to represent the normal risk, and the tangible assets are £90,000, show goodwill computed in accordance with the methods above stated.

	£
Method (1)	
Net Profit of £20,000 capitalized at 10 years' purchase	200,000
Less Tangible Assets	90,000
Goodwill	£110,000[1]
Method (2)	
Net Profit	20,000
Less 10% on £90,000	9,000
Super-profit	£11,000
Goodwill—10 years' purchase	£110,000[1]

Book-keeping Entries. Where one company acquires another, the general principles of accounting apply, but particular attention is required in dealing with the following matters—

(1) The purchasing company may place values on the assets taken over quite different from those appearing in the books of the vendor. The former are important in order to arrive at the goodwill or capital reserve figure; but of no importance in the vendor's books, unless they are the only means of ascertaining the purchase consideration.

(2) Losses and fictitious assets existing at the date of liquidation should be transferred out to the debit of Sundry Members; likewise profits—e.g. Share Premium Account, Debenture Redemption Fund—and capital credits—e.g. Capital Redemption Reserve Fund—to the credit of Sundry Members.

(3) Profits and losses occurring in and arising out of the liquidation should be credited or debited, as the case may be, to the Realization Account, including debtors and creditors taken over in the liquidation, etc.

(4) Where creditors are not taken over they will usually be formally paid out by the liquidator of the vendor company, e.g. if the purchase consideration is £50,000 plus the taking over of £10,000 liabilities, the purchasing company will have to enter £60,000 of liabilities, £50,000 to Vendor and £10,000 for liabilities. If on the other hand the liabilities are not taken over the purchase consideration will be £60,000 all due to the Vendor, so that, in fact,

[1] The same result can be arrived at only if the number of years' purchase (Method (1)) multiplied by rate of interest on capital (Method (2)) equals 100, e.g. if the former is taken at 12½ years, the latter will be taken at 8 per cent

instead of the purchasing company paying the individual creditors, it will pay one cheque therefor to the liquidator of the vendor company.

The vendor company may either—

(*a*) transfer £60,000 to the credit of Realization Account (and therefore *not* transfer the £10,000 from liabilities). The item of £60,000 will be debited to the purchasing company which will be credited with £10,000 on receipt of the cheque which will be used for payment of the creditors. (The remaining £50,000 will be credited when discharged and debited to the various assets comprised in the settlement); or

(*b*) debit the purchasing company and credit Realization Account with the true purchase consideration of £50,000, followed by a similar double-entry of £10,000 in respect of the liabilities, with subsequent entries as in (*a*).

(5) Items which are connected with those taken over should be transferred to Realization Account, e.g. Provisions for depreciation, bad debts and discounts, Leasehold Amortization Account.

(6) Where some of the assets (apart from cash) are not taken over, they will be dealt with on the usual lines by transfer to a Realization Account (preferably kept separate from that relating to the main realization) which will be credited with sale, etc., proceeds, the profit or loss being transferred (as with the main Realization Account) to Sundry Members. Alternatively, each asset account may be kept open until the asset is realized, the profit or loss being then transferred to Realization Account from which the net profit or loss is finally transferred to Sundry Members.

(7) Expenses of realization will be debited to Realization Account (or to the purchasing company if the latter agrees to pay them).

(8) The question arises with some items as to whether they are profits (or losses) or assets (or liabilities) or partly both. Such items are Employees' Pension Funds, Accident Compensation Funds, Superannuation Funds, and Employees' Profit-sharing Funds. These items will be treated on the principles already outlined according to their nature.

(9) Provision may be required to cover fractions (see page 993).

(10) The distribution of the assets of the vendor company will depend upon the Memorandum and Articles of that company; otherwise according to the general principles of law (see page 988).

From the book-keeping point of view the purchasing company is concerned only with the assets and liabilities taken over and not with the conventional items which go to complete the double entry in the books of the vendor company, such as the proprietorship element, however described, into which will be merged the profit and loss balance, debit or credit, and the fictitious assets. Care will be necessary with certain items as mentioned in (8) above.

Illustration. The following is the abridged Balance Sheet of X, Ltd. which is being taken over by Y, Ltd. Show the acquisition entries in the books of the latter, assuming that all assets and liabilities are taken over at their present valuation and ignoring the question of goodwill.

X, LTD.

BALANCE SHEET

	£		£
Share Capital	15,000	Fixed Assets	30,000
General Reserve	10,000	Current Assets	60,000
Leasehold Amortization Fund	15,000	Preliminary Expenses	2,000
Debenture Sinking Fund	10,000	Profit and Loss Account	8,000
Pension Fund	20,000		
Debentures	30,000		
	£100,000		£100,000

The estimated liability on Pension Fund is £14,000.

The Balance Sheet items may be classed as follows—

Real			Conventional	
		£		£
Fixed Assets		30,000	Share Capital	15,000
Current Assets		60,000	Reserve	10,000
			Debenture Sinking Fund	10,000
		90,000	Pension Fund	6,000
Less Debentures	£30,000			
,, Leasehold Amortization Fund	15,000			41,000
Pension Fund	14,000		*Less* Profit and Loss Account	8,000
		59,000		33,000
			,, Preliminary Expenses	2,000
		£31,000	Net Proprietorship	£31,000

The entries in the books of Y, Ltd. will therefore be—

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		£	£
Fixed Assets (detailed)	*Dr.*	30,000	
Current Assets (detailed)	*Dr.*	60,000	
To Debentures			30,000
,, Leasehold Amortization Fund			15,000
,, Pension Fund			14,000
,, X Ltd.			31,000

The "conventional" items will not appear in the books of Y, Ltd.

The opening entries on the acquisition of a business by a company will occasion no difficulty, as the assets *other than goodwill* will be debited and the liabilities taken over credited, as will be the amount due to the vendor. The excess of the purchase consideration over the net assets acquired (excluding goodwill) is debited to Goodwill Account; and in the converse case, the excess of net assets acquired after eliminating goodwill (if any) over the purchase consideration, credited to capital reserve, assets, or provision for depreciation.

The liability to the vendor will be discharged by a payment of cash and/or allotment of fully-paid shares and/or debentures.

The entries will be a debit to the vendor and a credit to cash, share capital and/or debentures.

Where, in addition to the net tangible assets acquired, the purchasing company discharges the realization expenses of the vendor, the amount is debited to goodwill or preliminary expenses and the vendor credited, unless the amount is already included in the credit to the vendor for purchase consideration. The cash in the latter instance will be debited to the vendor.

There may be a revaluation of assets, in which case the revised figures will be introduced into the books of the purchasing company, goodwill or capital reserve being modified accordingly.

Where debtors and/or stock are revalued (if taken over), the method is to retain the *book value intact* and provide for the reduced value of the debtors and/or stock by way of a provision.

In many examinations problems are set in which the values of the net tangible assets are not disclosed, but merely the details of liabilities taken over, together with the amount of purchase consideration. In these circumstances the amount of goodwill is not ascertainable unless given, or the necessary data for its computation provided.

Illustration. A, Ltd., acquires the business of L, Ltd., as a going concern, the purchase consideration being £3,700, to be discharged in 2,500 shares of £1 each fully paid at par, the balance in cash.

The assets and liabilities are taken over as follows—

	£	£
Debtors	3,250	
Stock	1,230	
Plant	1,000	
Creditors		720
Debentures		800
Rent owing		5

A, Ltd., agrees to pay out the debenture holders at 5% premium.

The debtors are revalued in the books of A, Ltd., at £2,500.

In addition, A, Ltd., is to discharge the realization expenses of L, Ltd., the amount thereof being £170.

Show the opening Journal entries in the books of A, Ltd.

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		£	£
Goodwill[1]	Dr.	535	
Preliminary Expenses (or Goodwill)	Dr.	170	
Debtors	Dr.	3,250	
Stock	Dr.	1,230	
Plant	Dr.	1,000	
To Debenture Holders of L, Ltd.			840
,, Debtors Provision			750
,, Creditors			720
,, Rent owing			5
,, Vendor			3,870
Being assets and liabilities taken over from L, Ltd., as per purchase agreement dated .... Opening assets and liabilities of A, Ltd.		£6,185	£6,185
Vendor	Dr.	3,870	
To Cash			1,370
,, Share Capital			2,500
Being satisfaction of purchase consideration			

Notes. (1) If the purchase consideration had been, say, £2,870, capital reserve would be £465 and the goodwill item eliminated.

(2) The cash to meet the realization expenses will be paid to the liquidator of L, Ltd.

(3) The amount due to vendor (L, Ltd.) is £3,870, viz. the purchase consideration £3,700 plus £170, as the question states that the latter amount is payable "*in addition.*"

Alternatively, a Business Purchase Account may be opened as below—

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		£	£
Goodwill	Dr.	535	
Preliminary Expenses	Dr.	170	
Debtors	Dr.	3,250	
Stock	Dr.	1,230	
Plant	Dr.	1,000	
To Debenture Holders of L, Ltd.			840
,, Debtors Provision			750
,, Creditors			720
,, Rent owing			5
,, Purchase of Business Account			3,870
Being assets and liabilities taken over from L, Ltd., as per vending agreement dated .... Opening assets and liabilities of A, Ltd.		£6,185	£6,185
Purchase of Business Account	Dr.	3,870	
To Vendor			3,870
Being purchase consideration for business taken over from L, Ltd., as per vending agreement dated			

[1] Balancing entry.

Illustration. X, Ltd., acquires the business of W, Ltd., the purchase consideration being: (1) cash payment of £1,200; (2) issue to the vendor of 2,000 shares of £1 each fully paid at par; (3) issue of £1,000 debentures at 95 per cent; (4) pay the realization expenses £130; and (5) assumption of liabilities £720.

Show the opening Journal entries, ignoring narratives.

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			£	£
Preliminary Expenses	Dr.		130	
Sundry Assets[1]	Dr.		4,870	
To Liabilities				720
,, Vendor				4,280
Vendor	Dr.		4,280	
Discount on Debentures	Dr.		50	
To Cash [i.e. £1,200 + £130]				1,330
,, Debentures				1,000
,, Share Capital				2,000

It should be noted that—

(1) In both illustrations a separate entry might be made for the payment of realization expenses of the vendor.

(2) If the liabilities were not disclosed, the "net assets" would be taken as £4,150.

(3) Goodwill is not known in the absence of the valuation of Sundry Assets.

Illustration. On 30th June, 19.., X, Ltd., was registered with a nominal capital of 6,000 ordinary shares of £1 each. The new company is to take over the old-established business of A. Vendor, the consideration being the allotment to him of 1,000 ordinary shares at par credited as fully paid. In addition, 1,500 ordinary shares are to be issued to him at par for cash.

On 6th July, the company offered to the public 3,500 ordinary shares of £1 each at a premium of 2s. per share, the whole having been underwritten at the same price, the underwriting commission being 4 per cent. Only 2,000 of the shares were subscribed for by, and allotted to, the public, the balance being allotted to the underwriters.

Five shillings per share was payable on application and 6s. per share on allotment, which included 2s. premium, and a first call of 4s. per share due on 30th September. The whole of the moneys due from the public were received and the company paid £84 on account of underwriting commission. At the date of allotment the underwriter pays in £1,650 in discharge of his liability. Give the Opening Journal entries and Balance Sheet. Ignore dates.

[1] Balancing item.

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	£	£
Sundry Net Assets . . . . . *Dr.*	1,000	
To A. Vendor		1,000
Being sundry assets taken over from A. Vendor as per agreement dated		
A. Vendor . . . . *Dr.*	1,000	
To Ordinary Share Capital . . .		1,000
Being discharge of consideration for assets taken over.		
Cash . . . . *Dr.*	1,500	
To Ordinary Share Capital . .		1,500
Being shares purchased by A. Vendor.		
Cash . . . . *Dr.*	500	
To Application and Allotment .		500
Being 5s. per share received on application for 2,000 shares.		
Application and Allotment . . . *Dr.*	1,100	
To Ordinary Share Capital . . .		900
,, Share Premium		200
Being allotment of 2,000 shares at £1 2s. per share, payable 5s. per share on application and 6s. per share on allotment (including 2s. premium) as per directors' resolution, etc.		
Cash . . . . *Dr.*	600	
To Application and Allotment . .		600
Being cash received on allotment.		
Underwriter . . . . *Dr.*	1,650	
To Ordinary Share Capital . . .		1,500
,, Share Premium		150
Being liability of underwriter on 1,500 shares of £1 each, at 22s. per share unapplied for.		
Cash . . . . *Dr.*	1,650	
To Underwriter		1,650
Being discharge of liability by underwriter.		
First Call . . . . *Dr.*	400	
To Ordinary Share Capital . . .		400
Being call of 4s. per share on 2,000 shares.		
Cash . . . . *Dr.*	400	
To First Call		400
Being cash received on 1st call being 4s. per share on 2,000 shares.		
Underwriting Commission . . . *Dr.*	154	
To Underwriter		154
Being underwriting commission of 4% on 3,500 shares issued at 22s. per share.		
Underwriter . . . . *Dr.*	84	
To Cash		84
Being payment on account of underwriting commission.		

BALANCE SHEET AS AT ....

	£		£
Authorized Capital—		Cash	4,566
6,000 Ordinary Shares of £1 each	£6,000	Sundry Assets . . .	1,000
		Underwriting Commission .	154
Issued Capital—			
4,000 Ordinary Shares of £1 each fully paid . .	4,000		
2,000 Ordinary Shares of £1 each—13s. per Share called and paid . . .	1,300		
Share Premium Account .	350		
Underwriter . . .	70		
	£5,720		£5,720

Illustration. The Balance Sheet of J. Halden was—

BALANCE SHEET AS AT 31ST DECEMBER, 1952

	£	£		£	£
Creditors	3,100		Sundry Assets . .		10,500
Less Reserve . .	100		Debtors . . .	6,720	
		3,000	*Less* Reserve . .	220	
Loans		2,000			6,500
J. Halden . . .		12,000			
	£	17,000		£	17,000

On 15th April, 1953, J. Halden, Ltd., was incorporated, taking over all the assets (except debtors) and the liability for loans; interest at 6 per cent per annum on the purchase price to be allowed to the vendor from 1st January, 1953, to the date of completion. The credit balance of J. Halden's capital to be satisfied by the issue of ordinary shares in J. Halden, Ltd.

The loanholders accept 8 per cent preference shares in discharge of their debts.

The company, as agent for the vendor, agrees to collect the debts, which realize £6,300, out of which they pay, as agent for the vendor, the creditors at the net figure shown in the Balance Sheet. Of the balance, they paid on account to J. Halden the sum of £1,000; the amount remaining undrawn by J. Halden, including interest, to be discharged in the form of £2,500 debentures at 96 and cash.

The new company is to be entitled to all the intervening profit (i.e. between 1st January, 1953, and 15th April, 1953).

Show the opening entries of J. Halden, Ltd., and the closing entries of J. Halden in respect of the above, assuming that the date of completion is 31st May, 1953. Take income tax at 9s. in the £.

In the books of J. Halden, Ltd.

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		£	s.	d.	£	s.	d.
1953 April 15	Sundry Assets . . . . *Dr.*	10,500	0	0			
	To Loans				2,000	0	0
	,, J. Halden [*See below*][1] .				8,500	0	0
	Being assets and liabilities taken over as on 31st December, 1952, in pursuance of purchase agreement dated						
May 31	Loans . . . . *Dr.*	2,000	0	0			
	To 8% Preference Share Capital				2,000	0	0
	Being issue of 2,000 8% preference shares of £1 each fully paid in settlement of loan holders' claims.						
	Interest[2] . . . . *Dr.*	212	10	0			
	To J. Halden . . .				116	17	6
	,, Income Tax . . .				95	12	6
	Being interest on purchase price of £8,500 at 6% for five months to 31st May, 1953, and tax at 9s. in £ thereon.						
	Cash . . . . . *Dr.*	6,300	0	0			
	To J. Halden . . .				6,300	0	0
	Being debts collected.						
	J. Halden . . . *Dr.*	1,000	0	0			
	To Cash				1,000	0	0
	Being payment on account of amounts collected.						
	J. Halden . . . *Dr.*	3,000	0	0			
	To Cash				3,000	0	0
	Being payment of creditors.						
	J. Halden . . . *Dr.*	10,916	17	6			
	Discount on Debentures . *Dr.*	100	0	0			
	To Ordinary Share Capital .				8,500	0	0
	,, Debentures . . .				2,500	0	0
	,, Cash				16	17	6
	Being discharge of liability to vendor by issue of 8,500 shares of £1 each fully paid, £2,500 debentures at 96%, and cash £16 17s. 6d.						

[1] and [2] see page 891.

In J. Halden's books

JOURNAL

		£	s.	d.	£	s.	d.
953 ril 15	Realization Account . . *Dr.*	10,500	0	0			
	To Sundry Assets . . .				10,500	0	0
	Being assets transferred to J. Halden, Ltd., as on 31st December, 1952, in pursuance of purchase agreement dated						
	Loan . . . . . *Dr.*	2,000	0	0			
	To Realization Account . .				2,000	0	0
	Being liability assumed by J. Halden, Ltd., in pursuance of purchase agreement dated........						
	J. Halden, Ltd.[1] . . *Dr.*	8,500	0	0			
	To Realization Account. .				8,500	0	0
	Being purchase consideration as per purchase agreement dated...						
ıy 31	J. Halden, Ltd. Interest[2] . *Dr.*	116	17	6			
	To J. Halden Capital . .				116	17	6
	Being interest at 6% per annum on £8,500 for 5 months—						
	£ s. d.						
	1st Jan., 1953, to 31st May, 1953 212 10 0						
	Less Income Tax at 9s. in £ . 95 12 6						
	£116 17 6						
	J. Halden, Ltd. Collection Account *Dr.*	6,300	0	0			
	Bad Debts Provision . . *Dr.*	220	0	0			
	J. Halden Capital . . *Dr.*	200	0	0			
	To Debtors				6,720	0	0
	Being final adjustment of debtors through the collection by J. Halden, Ltd.						
	Creditors . . . . . *Dr.*	3,100	0	0			
	To J. Halden, Ltd. Collection Account . . .				3,000	0	0
	,, Discount Received . .				100	0	0
	Being final adjustment of creditors through payments by J. Halden, Ltd.						
	J. Halden, Capital Account[3] *Dr.*	1,000	0	0			
	To J. Halden, Ltd., Collection Account . . .				1,000	0	0
	Being cash drawn against net collection by J. Halden, Ltd.						

[1] This is made up of the Capital Account of J. Halden after adjusting debtors and creditors, i.e. the "net" assets taken over.

[2] This will be charged against profit prior to incorporation.

[3] See footnote (1) on page 892.

JOURNAL—(*contd.*)

			£	s.	d.	£	s.	d.
1953 May 31	J. Halden, Capital [1] . . *Dr.*		10,916	17	6			
	To J. Halden, Ltd. . .					8,500	0	0
	,, J. Halden, Ltd. Collection[2]					2,300	0	0
	,, J. Halden, Ltd. Interest[2] .					116	17	6
	Being discharge of final balances by allotment of 8,500 shares of £1 each fully paid: £2,500 debentures at 96% and cash, £16 17s. 6d. for balance of interest.							

Profit Prior to Incorporation. A company cannot make profits nor incur losses prior to incorporation, so that where it is formed to take over a business from a date prior to its incorporation (usually being the date of the close of the last accounting period of the vendor concern) the profit or loss arising between the two dates must be kept quite apart from the profits or losses after incorporation. It may be noticed that the date of the certificate entitling the company to commence business (necessary in public companies) being purely a legal formality is quite immaterial to the present topic.

The vendor, in releasing his right to profit (a loss may be ignored at the moment), will normally require some compensation, either in the form of interest or an additional sum for goodwill. Therefore it is first necessary to compute the amount of pre-incorporation profit, against which will be debited the interest (if any) payable

[1] It will be observed that the vendor receives £11,916 17s. 6d. This sum is accounted for as follows—

		£	s.	d.
(*a*) Capital per Balance Sheet		12,000	0	0
Less loss on Bad Debts—	£			
Book Value of Debtors . .	6,720			
Less Provision . . .	220			
	6,500			
Amount realized . .	6,300			
		200	0	0
		11,800	0	0
Add Interest on purchase price, *less* tax		116	17	6
		£11,916	17	6

[2] The balance due to J. Halden after the allotment of shares is £2,416 17s. 6d discharged as follows—

	£	s.	d.
(*a*) £2,500 Debentures at 96% . . .	2,400	0	0
(*b*) Cash	16	17	6
	£2,416	17	6

A transfer of £100 might be made from Interest Account to Collection Account, bringing the latter up to £2,400 and the former down to £16 17s. 6d. discharged respectively by Debentures and Cash (as above).

to the vendor; if there still remains a balance of pre-incorporation profit, this is in the nature of a capital profit and not available for distribution amongst the members of the company.

Illustration. A company is incorporated to take over a business as and from 1st January, 1953, the company being incorporated on 31st March, 1953, followed in due course by the receipt of its certificate entitling it to commence business. The profit for the year ended 31st December, 1953, is £3,200 (before debiting interest to vendor), of which the proportion attributable to the three months ended 31st March is £600. The vendor is entitled to 10 per cent interest per annum on the purchase consideration of £14,000, up to the date of incorporation. Ignore income tax.

ALLOCATION OF PROFIT

	Pre-Incorporation	Post-Incorporation	Total
	£	£	£
Profit	600	2,600	3,200
Less Interest to Vendor at 10% p.a. on £14,000 for 3 months: 1st Jan., 1953, to 31st March, 1953	350		350
Balance	£250	£2,600	£2,850
Disposal	Capital Reserve	Available for Dividend	

Instead of receiving interest, the vendor may increase the purchase consideration by the estimated profit (if possible), so that the "excess" figure will be automatically added to goodwill; therefore the pre-incorporation profit will be credited not to a capital reserve, but to GOODWILL, so as to cancel the amount originally included therein representing estimated profit. It is extremely improbable that the *actual* profit will correspond with the estimated profit, hence there will almost invariably be a difference between the estimate and actual. This may, in case of a profit balance, belong to the purchasing company or to the vendor, according to agreement. The converse position would arise in case of a loss balance.

Illustration. Same facts as before, except that the purchase consideration is £14,600 without interest, and assuming that £14,000 represents book values of tangible assets at 1st January, journalize (without narrative) the opening entries of the purchasing company.

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			£	£
Assets . . . . . . *Dr.*			14,000	
Goodwill . . . . . *Dr.*			600	
To Vendor				14,600

Disposal of profit will be—

(*a*) Pre-incorporation profit, £600 will be transferred to Goodwill.

(*b*) Post-incorporation profit, £2,600 will be available for dividend.

The Goodwill Account will subsequently be eliminated thus—

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			£	£
	Profit and Loss Account (Pre-Incorporation) *Dr.*		600	
	To Goodwill			600

Illustration. Show the treatment, assuming the same facts as in the preceding illustration, except that the ACTUAL pre-incorporation profit is £850; the total profit for the year remaining the same, £3,200.

ALLOCATION OF PROFIT

Pre-Incorporation	Post-Incorporation	Total
£850	£2,350	£3,200

The pre-incorporation profit will be disposed of by transferring £600 thereof to the credit of Goodwill Account and £250 to the credit of capital reserve or, if the agreement so provides, to the credit of the vendor. The post-incorporation profit is available for dividend.

If there have been drawings on the part of the vendor, the balance payable to the vendor will be *pro tanto* reduced.

Loss Prior to Incorporation. Any loss prior to incorporation may be dealt with thus—

(*a*) debited against the profits after incorporation.

(*b*) debited to a special account headed "Loss prior to Incorporation"; or

(*c*) debited to Goodwill Account.

The same principle in (*b*) and (*c*) applies as in the case of a profit prior to incorporation. If the purchase consideration is based upon the position as at the date of the last Balance Sheet without reference to a subsequent loss, the vendor agreeing to forgo all question of profit and conversely being released from any loss, then logically the vendor ought to ALLOW interest to the purchaser, although this is obviously a very rare occurrence.

Illustration. A company sells its business to another as and from 1st January, 19.., the purchasing company being incorporated on the 31st March, 19... The purchase consideration is £14,000, but

as the parties are aware there has been a loss during the three intervening months, it is agreed that the purchasing company will bear all the loss, subject to the vendor allowing interest at 10 per cent per annum for the period 1st January, 19.., to 31st March, 19.., on the purchase consideration. The loss for the year ended 31st December, 19.., is £3,200 apart from interest, of which £600 is attributable to the pre-incorporation period.

ALLOCATION OF LOSS

	Pre-Incorporation	Post-Incorporation	Total
	£	£	£
Loss	600	2,600	3,200
Less Interest due from Vendor at 10% p.a. on £14,000 for 3 months to 31st March, 19..	350		350
	£250	£2,600	£2,850
Disposal	[1] Carried forward	[2] Carried forward	

Where no interest is to be calculated and the purchase price is to be reduced by the estimated loss of £600 (assuming the estimated losses to mature exactly into an actual loss of £600), there will be a provision made in the opening entries against which the loss will be debited.

Illustration. Same facts as in the preceding example, except that no interest is to be computed and the purchase consideration has been reduced by £600. Show the opening Journal entry.

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			£	£
	Assets . . . . *Dr.*		14,000	
	To Vendor			13,400
	,, Provision[3]			600

Disposal of loss will be—

(*a*) Pre-incorporation loss £600 will be offset against the Provision.

(*b*) Post-incorporation loss £2,600 will be carried forward till eliminated by subsequent profits.

The entry (*a*) will cancel the Provision credited in the opening entry.

[1] This item will be shown in the Balance Sheet as an "asset" till written off

[2] This item will be shown in the Balance Sheet as an "asset" till eliminated by subsequent profits.

[3] The "profit" of £600 is illusory, as the value of the assets although appearing in the books at £14,000 is diminished by the loss of £600.

If the loss were £850 instead of £600, the debit balance of £250 would be transferred either to the debit of vendor, if the agreement so provides, or to Loss prior to Incorporation Account.

Where interest is charged *by* the vendor, such interest will be an *additional* loss, so that using the figures already given the loss of £600 would be increased by £350 interest to £950, and be dealt with as a loss prior to incorporation.

If it should happen that there is a loss prior to incorporation and a profit after incorporation, the former may be set off against the latter, thus reducing the divisible profit.

Where the loss prior to incorporation is debited against goodwill, this is correct only if the amount of goodwill is at the opening a balancing figure, for if the *true* goodwill has already been debited, no subsequent losses can increase it, but rather the reverse.

Illustration. Same facts as previously, except that tangible assets at a book value of £14,000 are purchased for £15,800. Loss prior to incorporation is £600. Show opening Journal entry.

It is obvious that the goodwill figure in the opening entry is £1,800; but this is based upon the book values at 1st January. Yet at the time of incorporation the assets had fallen in value (apart from other fluctuations) by £600, leaving the true book value at £13,400; hence the goodwill is the purchase consideration (£15,800) less the true value of assets (£13,400); that is, £2,400. At the date of the opening entry the 1st January figures are entered thus—

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				£	£
	Assets . . . . . . Dr.			14,000	
	Goodwill . . . . . . Dr.			1,800	
	To Vendor				15,800

When the loss is ascertained at the end of the year, viz. £600, the amount will be transferred to the debit of goodwill, increasing it to £2,400.

If the opening entry is adjusted to cover the estimated loss at the date of purchase, it would be as follows—

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				£	£
	Assets (old Book Value) . . . . Dr.			14,000	
	Goodwill . . . . . . Dr.			2,400	
	To Vendor				15,800
	,, Provision				600

The debit for loss prior to incorporation will be offset against the provision £600, thereby eliminating it.

If the business had been acquired on the basis that the loss to 31st March, 19.., was only £600 (and it turns out to be £1,000), then the extra loss of £400 must be transferred to Loss prior to Incorporation Account. This is justified because the purchasers contemplated the tangible assets to be £13,400 (paying £15,800 therefor), but the assets were £400 less than they imagined, for which, had they known it, they would have paid only £15,400.

Summary of Treatment of Profit Prior to Incorporation. (1) Where assets are taken over and paid for on the basis of the last Balance Sheet, the vendor taking the whole of the profit between the latter date and the date of the incorporation of the company, no charge being made for Goodwill.

(2) Where the vendor increases the sale price of the business to cover the whole of the profit indicated in the foregoing paragraph, no charge being made for Goodwill.

(3) Where the vendor surrenders the whole of the profit indicated in paragraph (1) and charges interest on the purchase price in lieu thereof, no charge being made for Goodwill.

(4) Where, in addition to the purchase price, either with or without the addition of interest, the purchasing company is required to pay for Goodwill.

In the above instances the pre-incorporation profit will be (referring to each paragraph)—

(1) eliminated,

(2) eliminated, and

(3) the excess of profit over interest credited to Capital Reserve or, in the converse instance, debited to Loss prior to Incorporation Account or Goodwill Account.

As to (4) there will be a Goodwill Account opened, so that any excess interest over profit must be debited to Loss prior to Incorporation Account.

Where the pre-incorporation profit exceeds that estimated in fixing the purchase price, the excess will be credited to Capital Reserve; in the converse case, debited to Loss prior to Incorporation Account if paragraph (4) applies, otherwise Loss prior to Incorporation Account or Goodwill Account.

Similar principles, conversely treated, will apply to Loss prior to Incorporation.

Therefore, it is of vital importance to be acquainted with the DETAILS of the constitution of the PURCHASE CONSIDERATION.

Methods of Computing Profit Prior to Incorporation. (1) By the taking out of accounts, either with or without closing off the books, whereby the actual profit or loss up to the date of incorporation is ascertained, such profit or loss being credited or debited to the

vendor, or transferred on the lines already outlined. The simplest, but not always the most expedient, method is to close off the old books; the new books of the purchaser being opened with the assets as they exist at the date of incorporation, thus automatically including the results to that date; the difference between the assets acquired and purchase consideration being goodwill or reserve. If the purchase consideration EXCEEDS book values, the balancing item is a debit for goodwill; if it is LESS than book values, the balancing item is CAPITAL (or depreciation or asset) reserve. The accounts will then relate exclusively to the post-incorporation period, and adjustments for pre-incorporation profit or loss will not be required.

(2) By taking the gross profit on a percentage basis of sales, and apportioning it into the "pre" and "post" periods on either TIME or SALES basis, the expenses against the gross profit being split according to the circumstances, viz.—

(i) Common charges:

(*a*) Fixed charges on actual facts or on a time basis, e.g. rates, insurance.

(*b*) Fluctuating charges on the basis appropriate thereto, e.g.—

Bad debts according to the dates they became bad or upon credit sales.

Discount allowed and received according to the dates of allowance or the date the debts were incurred.

Carriage out according to the dates of sales.

(ii) Non-common charges. These will be dealt with according as they belong to the "pre" or "post" periods, and normally are not split, e.g. directors' fees, if the vendor is not a limited company. These must exclusively belong to the "post-incorporation" period. Similarly, formation expenses, although necessarily incurred in point of time prior to the incorporation of the company, will not be introduced into the books until the "post-incorporation" period, as they are expended EXCLUSIVELY for the purchasing company. Thus, the procedure is—

(*a*) to apportion gross profit according to the sales prior to or after incorporation, or according to the respective periods prior to or after incorporation;

(*b*) to apportion the expenses according to the facts; leaving

(*c*) two profits and/or losses, viz. before and after incorporation.

Illustration. Perwick, Ltd., was incorporated on 1st April, 1953, taking over a business as and from the preceding 1st January. The net sales for the year ended 31st December, 1953, are £125,000, £25,000 of which were made during the three months ended 31st March, 1953.

The gross profit for the year is £40,000; general expenses are

£26,000, and *include* directors' fees, £2,000; issued share capital is £60,000, in ordinary shares of £1 each fully paid.

It is decided to place £3,000 to reserve.

Show Profit and Loss Account, basing the apportionment of gross profit on sales. Ignore income tax and preliminary expenses.

PERWICK, LTD.

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 1953

Dr. *Cr.*

		Pre-Incorporation	Post-Incorporation			Pre-Incorporation	Post-Incorporation
		£	£			£	£
To General Expenses[1]		6,000	18,000	By Gross Profit[2]	b/d	8,000	32,000
,, Directors' Fees			2,000				
,, Net Profit	c/d	2,000	12,000				
		£8,000	£32,000			£8,000	£32,000
To Reserve			3,000	By Net Profit	b/d	2,000	12,000
,, Interest to Vendor		?					
,, Balance to Capital Reserve		2,000					
,, Balance	c/d		9,000				
		£2,000	£12,000			£2,000	£12,000
				By Balance	b/d		9,000

Illustration. A company acquires a business as on 1st January, 1953, it being incorporated on the 1st May, 1953. The first accounts are drawn up to the 30th September, 1953.

The gross profit is £5,600.

The general expenses are £1,422; directors' fees, £1,200 per annum; formation expenses, £150.

Rent to 30th June was £120 per annum, after which it was increased to £300 per annum.

Salary of the manager, who upon incorporation of the company was made a director, was £600 per annum (since incorporation included in directors' fees above).

Show Profit and Loss Account, assuming that the net sales were £82,000, the monthly average of which for the first four months of 1953 being one-half of that of the remaining period. The commodity earned a uniform profit. Interest and tax may be ignored.

[1] Apportioned on a time basis, i.e. 3 : 9.

[2] Apportioned on sales basis, i.e. 25 : 100.

PROFIT AND LOSS ACCOUNT FOR THE NINE MONTHS ENDED 30TH SEPTEMBER, 1953

Dr. *Cr.*

		Pre-Incorporation	Post-Incorporation			Pre-Incorporation	Post-Incorporation
		£	£			£	£
To General Expenses (*b*) .		632	790	By Gross Profit *a*) . .	b/d	1,600	4,000
,, Rent (*c*) . . .		40	95				
,, Manager's Salary . .		200					
,, Directors' Fees (*d*)			500				
,, Formation Expenses (*e*)			150				
,, Capital Reserve (or Goodwill) . .		728					
,, Balance	c/d		2,465				
		£1,600	£4,000			£1,600	£4,000
				By Balance . . .	b/d		2,465

(*a*) The profit is apportioned in the ratio of 2 : 5.
If the first four months sales be represented by 1 then subsequent sales will be represented by 2, but as the number of months in first period is four and in the second five, the ratio is computed thus—

$$\begin{array}{lcccccc} \text{Pre-incorporation} & = & 1 \times 4 & = & 4 & = & 2 \\ \text{Post-incorporation} & = & 2 \times 5 & = & \underline{10} & = & \underline{5} \\ & & & & \underline{\underline{14}} & = & \underline{\underline{7}} \end{array}$$

(*b*) In absence of information, apportioned on time basis, i.e. 4 : 5.

(*c*) 4 months at £10 a month = £40 (to 1st May, 1953).
2 months at £10 a month, plus 3 months at £25 a month = £95 (to 30th Sept., 1953).

(*d*) Directors' fees, five months (to 30th Sept., 1953), at £100 a month.

(*e*) Strictly, to Appropriation Account. Formation expenses may, alternatively, be written off against pre-incorporation profits.

Illustration. X, Ltd., was incorporated on 1st July, 1953, and acquired from Y as and from 1st January, 1953, the business carried on by him. The purchase price of the fixed assets and goodwill was defined by the agreement as a sum equal to 75 per cent of the profits of the business for twenty years from 1st January, 1953, payment to be made each year on the ascertainment of the sum due.

The following were the balances as on 31st December, 1953, after closing the Trading Account.

Debits	£	*Credits*	£
Debtors	600	Share Capital . . .	1,200
Stock at cost	750	Creditors	1,150
Bank	2,900	Profit for the year *after* providing for Income Tax and charging all other expenses allowable under Purchase Agreement . . .	2,400
Preliminary Expenses . .	200		
Directors' Fees	300		
	£4,750		£4,750

Write off one-quarter of the Preliminary Expenses and set out *draft* Balance Sheet as on 31st December, 1953; and Profit and Loss Appropriation Account, showing profit prior to incorporation.

X, LTD.

Draft PROFIT AND LOSS APPROPRIATION ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 1953

Dr.	[1]	[2]	*Cr.*	[1]	[2]
	£	£		£	£
To Preliminary Expenses		50	By Net Profit	1,200	900
" Balance	1,200	850			
	£1,200	£900		£1,200	£900

Draft BALANCE SHEET AS AT 31ST DECEMBER, 1953

	£	£		£	£
Share Capital		1,200	Bank	2,900	
Capital Reserve—Profit prior to Incorporation		1,200	Debtors	600	
Profit and Loss Account		850	Stock	750	4,250
Creditors—			**Fixed Assets and Goodwill**		**1,800**
General	1,150		Preliminary Expenses	200	
Vendor	**1,800**	2,950	*Less* written off	50	150
		£6,200			£6,200

Notes. (*a*) The amount of £1,800 is the sum payable for the acquisition of Fixed Assets and Goodwill, arrived by taking three-quarters of the profit of the company for the year £2,400. The student must note that the basic figure is not £2,100, i.e. £2,400 *less* Directors' Fees £300, because the question clearly states otherwise: further, if the new company could charge up Directors' Fees indiscriminately it could deprive the Vendor of *any* sum for the Fixed Assets and Goodwill by utilizing all the profits of the company in payment of Directors' Fees.

(*b*) The apportionment of profit prior to incorporation is upon a time basis, i.e.—

	£	£
Prior to incorporation, one-half of £2,400		1,200
Subsequent to incorporation, one-half of £2,400	1,200	
Less Directors' Fees	300	900
		£2,100

(*c*) As a matter of prudence a Reserve may be created to cover the sum of £1,800 payable to the Vendor by first utilizing the profit prior to incorporation of £1,200 and the sum of £600 out of profits subsequent to incorporation.

(*d*) It is assumed that Income Tax is "allowable" as the question states: ". . . after providing for Income Tax and charging all *other* expenses allowable."

[1] Profit prior to incorporation.
[2] Profit since incorporation.

Apportionment of Shares Between Vendors. Difficulties sometimes arise in the division of shares received from a purchasing company in the lack of agreement between the vendors.

Where partners are vendors, the problem is so to apportion the shares in the new company as to preserve the original positions of the partners as enjoyed in the partnership, viz. (*a*) to maintain the same divisibility of profits; and (*b*) to preserve the same priority as to the right of repayment of capital.

The rules may be summarized, ignoring income tax—

(1) Where a partner has made a loan or advance to the partnership, he should take a first preference share with dividend at the same rate as interest on the loan.[1]

(2) [2] Surplus capital; second preference share with or without dividend right.[1]

(*a*) If no interest on capital—no dividend.

(*b*) If interest on capital—same rate of dividend as the interest paid in the partnership.

The above shares to be preferential as to capital, the shares in (1) having priority over the shares in (2).[1]

(3) The balance of all shares in profit and loss ratios.

(4) Partnership salaries as before.

Where the capitals of the partners are proportionate to profit sharing, the *whole* of the share capital of the company will be so divided, it being immaterial whether interest on capital in the partnership was charged or not.

Where income tax comes up for consideration—as in most cases it undoubtedly will—the above rules are modified so as to give the directors their income from the company in the form of directors' fees and not as dividends. This point is illustrated on page 904 *et seq.*

Illustration. A, B, and C are in partnership, sharing profits in the ratio of 2 : 2 : 1 after providing for interest on capital at 5 per cent per annum, and salaries of £200 to B and £150 to C. They decide to form a limited company to take over the business. The assets and liabilities are to be taken over at book values with the exception of goodwill, the value of which is to be taken at an increase of £5,000. The capitals of A, B, and C at the date of purchase by the limited company were £8,000, £6,000, and £3,500.

Show how you would deal with the allocation of capital of the partners in the new company so as to preserve the same rights as between themselves as obtained in the partnership.

(1) The capitals of the partners in the business are not proportional to their shares in profits and losses.

[1] Alternatively, instead of first and second preference shares, debentures may be issued for (1) and preference shares for (2).

[2] See page 903.

(2) The Capital Accounts after writing up assets will be as follows—

	A	B	C
	£	£	£
Capitals	8,000	6,000	3,500
Add Increase in Assets in ratio 2 : 2 : 1	2,000	2,000	1,000
Revised Capitals £	10,000	£8,000	£4,500

(3) If the capitals were in profit-sharing ratios, and assuming C's capital to be in the same proportion to the total capital as his share of profit, the relative excess capitals would be as follows—

	A	B	C
	£	£	£
Capitals as above	10,000	8,000	4,500
Less Capitals in the Profit-sharing ratio	8,000	8,000	4,000
Surplus Capital held by A and C over B	2,000	—	500
As between A and C profits are divided in proportion of 2 : 1. Assuming, therefore, C's surplus Capital of £500 to represent one-third, the Capitals would be	1,000		500
Surplus Capital of A over C	£1,000		

In the event of a winding-up therefore, A should receive £1,000 before B and C are repaid anything. The next £1,500 should be shared by A and C in the ratio of 2 : 1, and the balance between A, B, and C in the ratio of 2 : 2 : 1.

(4) (i) In order that the ultimate net profit shall continue to be shared in the proportions of 2 : 2 : 1, ordinary shares must be issued to the partners in those proportions in respect of part of their capital.

(ii) To equate the rights of the partners as to interest on capital, preference shares carrying 5 per cent per annum interest may be issued for the balance of the respective capitals.

(iii) The priorities as to repayment of capital attaching to the various classes of shares must be made to conform to the present rights of the partners in regard to repayment of capitals and loans in the partnership.

(5) Capital may thus be issued—

(i) £1,000 5 per cent "A" cumulative preference shares of £1 each issued to A in respect of his absolute surplus of capital, such shares to have priority over all other shares as to repayment of capital in the event of liquidation.

(ii) £1,000 5 per cent "B" cumulative preference shares of £1 each to be issued to A and £500 5 per cent "B" cumulative preference shares to be issued to C in respect of their surplus of capital

over that of B, such shares to rank *pari passu* with "A" preference shares as to dividend and next after the "A" preference shares as to repayment of capital in the event of liquidation.

(iii) None of the above preference shares to be entitled to share in any surplus of assets remaining on a winding-up, except to the extent of all arrears of preference dividend due on such shares.

(iv) Ordinary shares, ranking for dividend and repayment of capital after all preference shares, and carrying the right to participate in any surplus of assets on a winding-up to be issued as follows: A, £8,000; B, £8,000; C, £4,000.

(v) Directors' fees of £200 and £150 per annum to be paid to B and C respectively to take place of the salaries hitherto paid to them.

(vi) The distribution of profits in the partnership and the company respectively is illustrated by the following statements (using the foregoing data).

Profits assumed, £5,225.

PARTNERSHIP

	A	B	C
	£	£	£
Interest on Capital—			
5% on £10,000 . .	500		
5% on £8,000 . .		400	
5% on £4,500 . .			225
Salaries		200	150
Balance, 2 : 2 : 1 . .	1,500	1,500	750
	£2,000	£2,100	£1,125

COMPANY

	A	B	C
	£	£	£
5% "A" Preference Share Dividend . . .	50		
5% "B" Preference Share Dividend . . .	50		25
Directors' Fees . .		200	150
[*See below*]	100	200	175
Dividends on— Ordinary Shares .	1,900	1,900	950
	£2,000	£2,100	£1,125

In order to obtain the benefit of the Earned Income Allowance for A, B, and C, provided the business profits are sufficient, the directors would treat profits as fees, so as to provide C (the partner with the lowest income) with the maximum Earned Income Allowance ($\frac{2}{9}$ths of £2,025 for 1953–54).

Divisible profits (if sufficient) will, therefore, be distributed as directors' fees up to the maxima indicated below.

	A	B	C
	£	£	£
Apportionment (as above)	100	200	175
Balance, 2 : 2 : 1	3,700	3,700	1,850
	£3,800	£3,900	£2,025

As, however, A and B might object, inasmuch as they would be liable for sur-tax, the alternative procedure would be to bring B's income down to £2,000 in order to avoid such liability (although it must be remembered that the Inland Revenue authorities may

raise an assessment on the company for sur-tax in respect of profits unreasonably withheld from distribution)—

	A	B	C
	£	£	£
Apportionment (as on page 904) . .	100	200	175
Balance, 2 : 2 : 1	1,800	1,800	900
See also paragraph 3, page 906.	£1,900	£2,000	£1,075

If priority as to capital were not important, shares (all equal in rank as to capital and dividends) might be allotted thus—

		£
A.	20,000 Shares of 10s. each fully paid	10,000
B.	20,000 Shares of 8s. each fully paid	8,000
C.	10,000 Shares of 9s. each fully paid	4,500

Dividends would be payable on the nominal number of the shares allotted. The special first distribution of A, £100; B, £200; C, £175, must be maintained.

Illustration. The different methods may be compared, assuming profit of £10,475 all to be distributed and the facts as before.

(1) As partners—

	£	£	£
Interest on revised Capital	500	400	225
Salaries		200	150
Balance, 2 : 2 : 1	3,600	3,600	1,800
[1]	£4,100	£4,200	£2,175

(2) Company, whereby C is to have £2,025 as director's fee.

			A	B	C
			£	£	£
5% "A" Preference Dividend[2] . .			50		
5% "B" Preference Dividend[2] . .			50		25
Directors' Fees				200	[3] 150
Additional Directors' Fees . . .			3,750	3,750	[3] 1,875
			3,850	3,950	2,050
Dividend: Ordinary Shares at $3\frac{1}{8}\%$	A	£8,000			
	B	8,000			
	C	4,000			
			250	250	125
			£4,100	£4,200	£2,175

[1] Alternatively Interest on Capital might be calculated upon the original capitals and the balance divided in profit ratios, the result being the same as above.

[2] If the partnership capitals did not carry interest, no dividend would be payable on these shares.

[3] Total *earned* Income of C = £2,025, being the maximum earned income upon which the two-ninths earned income allowance is given, i.e. £450 in 1953–54.

(3) Company, whereby B is to have £2,000 as director's fee—

	A	B	C
	£	£	£
Directors' Fees (made up as on page 905)	1,900	2,000	1,075
Dividends: Ordinary Shares at 27½% { A £8,000, B 8,000, C 4,000 }	2,200	2,200	1,100
	£4,100	£4,200	£2,175

(4) Company, whereby the whole of the profit, except for preference dividends and B's director's fee £200 and C's director's fee £150, is to be paid in dividends on Ordinary Shares—

	A	B	C
	£	£	£
Apportionment (see page 905[1]) . .	100	200	175
Dividends: Ordinary Shares at 50% { A £8,000, B 8,000, C 4,000 }	[1] 4,000	[1] 4,000	[1] 2,000
	£4,100	£4,200	£2,175

In a winding-up, should there be a loss, it would be charged first against the ordinary shares, then against the "B" Preference shares and any balance, lastly, against the "A" Preference shares. The comparative position between the partnership and the limited company is shown in the following illustrations.

Illustration. Assuming that the new company went into immediate liquidation and the assets produced £21,000, there would be a loss of £1,500 (i.e. £22,500 – £21,000), borne as follows—

PARTNERSHIP

	A	B	C
	£	£	£
Capital	10,000	8,000	4,500
Loss 2 : 2 : 1 . .	600	600	300
Repay	£9,400	£7,400	£4,200

LIMITED COMPANY

	A	B	C
	£	£	£
Ordinary Shares . .	8,000	8,000	4,000
Less Loss	600	600	300
	7,400	7,400	3,700
"B" Preference Shares .	1,000		500
"A" Preference Shares .	1,000		
Repay	£9,400	£7,400	£4,200

Illustration. If the assets produced £2,100 only, involving a loss of £20,400.

[1] Alternatively, these sums might be treated as additional directors' fees.

PARTNERSHIP	A	B	C	LIMITED COMPANY	A	B	C
	£	£	£		£	£	£
Capital . . .	10,000	8,000	4,500	Ordinary Shares .	8,000	8,000	4,000
Loss 2 : 2 : 1 . .	8,160	8,160	4,080	*Less* Loss . . .	8,000	8,000	4,000
	Repay £1,840	Due £160	Repay £420		—	—	—
				"B" Preference Shares .	1,000	—	500
Advantage (+) or disadvantage (−) compared with Company.	+£107	−£160	+£53	*Less* Balance of Loss . (£20,400 − £20,000)	267	—	133
					733	—	367
				"A" Preference Shares .	1,000	—	—
				Repay	£1,733	*nil*	£367

Illustration. If the loss on liquidation is £21,900, the assets producing £600 only.

PARTNERSHIP	A	B	C	LIMITED COMPANY	A	B	C
	£	£	£		£	£	£
Capital . . .	10,000	8,000	4,500	Ordinary Shares as above	—	—	—
Loss 2 : 2 : 1 . .	8,760	8,760	4,380	"B" Preference Shares	1,000	—	500
	Repay £1,240	Due £760	Repay £120	*Less* Loss . . .	1,000	—	500
					—	—	—
Advantage or disadvantage as above .	+ £640	− £760	+ £120	"A" Preference Shares .	1,000	—	—
				Less Balance of Loss . (£21,900 − £21,500)	400	—	—
				Repay . . .	£600	*nil*	*nil*

Thus B with the lowest relative capital gains materially in the company at the expense of A and C, whilst the capital loss of A is much heavier than that of C.

Had the two preference shares been of the same status in a liquidation, the position would have been—

	A	B	C
	£	£	£
Ordinary Shares as above	—	—	—
Preference Shares "A" and "B"	2,000		500
Less balance of loss (£21,900 − £20,000) shared 20 : 5	1,520		380
Repay.	£480	*Nil*	£120

Debtors' and Creditors' Suspense Accounts. Where, as is usual, the purchasing company collects debts as agent for the vendor, and out of the proceeds pays the creditors on behalf of the vendor the procedure is to open Suspense Accounts for both debtors and

creditors as they stand in the books at the date of the transfer, the *contras* therefor being the Debtors and Creditors Accounts.

The Ledgers will be continued in the ordinary way, but all receipts, together with allowances, discounts, and returns, must be separately dealt with, and this procedure may be facilitated by the employment of separate columns in the Cash Book. Alternatively, the balances are entered on a separate schedule against which the receipts or payments with discounts and the like are placed, thus showing the balances outstanding, if any, at the end of the financial year.

The double entry will, therefore, be as follows—

(1) **For Debtors**—

Debit Sundry Debtors balances (or Total Account) in Ledger Credit Debtors' Suspense Account	for opening balances.
Debit Cash (*a*) Debit Debtors' Suspense Account (*b*) Credit Sundry Debtors Accounts (*c*)	(*a*) for cash received from debtors. (*b*) for allowances, etc., to debtors. (*c*) for cash and allowances, etc. [i.e. total of (*a*) and (*b*).]
Debit Debtors' Suspense Account Credit Vendor	for cash received from debtors.

Entries will be made by way of memorandum in the Schedule for an appropriate adjustment to be made in the total account (if any).

The vendor thus becomes a creditor for the cash received by the purchasing company in respect of the debts due to the vendor, just as if he had himself collected the cash from his debtors and remitted the proceeds to the purchasing company.

(2) **For Creditors** (reverse to those outlined in respect of debtors[1])—

The vendor thus becomes a debtor for the cash paid to his creditors by the purchasing company.

The balance of the cash collected, less paid, will represent the amount due to or by the vendor arising from debtors and creditors, subject to any collection expenses. The balances of the Suspense Accounts will be equal to the balances of debtors and creditors existing at the date of purchase still remaining in the Ledgers.

Where allowances are made to debtors it is important to debit them to the Debtors' Suspense Account, not being losses of the purchasing company, and where allowances are granted by creditors the amounts thereof should be credited to the Creditors' Suspense Account. In the event of there being a commission given by the vendor to the purchasing company in respect of collection, the entry should not intrude upon those required for the transactions already enumerated; the amount will, before settlement of the balance due to or by the vendor (or at the end of the financial period, if such settlement has not already taken place), be debited to the vendor and credited to Commission Account.

[1] Creditors substituted for Debtors.

The entries in respect of creditors will conform to the same principles.

Illustration. A, Ltd., in taking over the business of A, agrees to collect the debtors at a commission of 5 per cent on net cash collected. The usual discount may be allowed to the debtors. Assuming that the discounts allowed are in order, write up the necessary Ledger Accounts from the following information—

	£
Debtors outstanding at the date of transfer . . .	2,560
Cash collected by A, Ltd., during the past financial year .	1,200
Discounts allowed in respect of the above do. . .	42

The balance due to vendor to be discharged at the end of each financial year as follows: one-half in cash; one quarter in shares of £1 each fully paid of the new company at a premium of 5s.; and the balance in 3 per cent War Loan, the price of which may be assumed to be 95.

Calculate to nearest £.

Dr. SUNDRY DEBTORS *Cr.*

		£			£
To *Balances* . . .		2,560	By Cash		1,200
			" Discount allowed .		42
			" Balances .	c/d	1,318
		£2,560			£2,560
To Balances . . .	b/d	1,318			

Dr. DEBTORS' SUSPENSE *Cr.*

		£			£
To Discount allowed . .		42	By *Sundry Debtors* . .		2,560
" Vendor . . .		1,200			
" Balances . . .	c/d	1,318			
		£2,560			£2,560
			By Balances . . .	b/d	1,318

Dr. CASH *Cr.*

		£			£
To Sundry Debtors . .		1,200	By Vendor		570
			" Vendor re £300 3% War Loan . . .		285
			" Balance . .	c/d	345
		£1,200			£1,200
To Balance . . .	b/d	345			

Dr. VENDOR *Cr.*

		£			£
To Commission on Cash Collected . . .		60	**By Debtors' Suspense Account: Cash collected from Debtors** . .		1,200
" Cash		570			
" £300 3% War Loan purchased . . .		285			
" Allotment Account .		285			
		£1,200			£1,200

Dr.	ALLOTMENT			Cr.
	£			£
To Share Capital Account .	228	By Vendor . . .		285
„ Share Premium . .	57			
	£285			£285

Items in *italics* are opening balances.

Dr.	SHARE CAPITAL		Cr.
			£
		By Allotment Account .	228

Dr.	SHARE PREMIUM		Cr.
			£
		By Allotment Account .	57

Dr.	COMMISSION		Cr
			£
		By Vendor . . .	60

The Debtors' and the Debtors' Suspense Accounts are reflective and will not appear in the Balance Sheet.

The cash balance of £345 is accounted for thus—

	£
Commission	60
Share Capital	228
Premium on Shares	57
Total . . .	£345

Several different methods are employed to separate the receipts from the old debtors from those arising from the new debtors.

The most important are—

(1) The "Schedule" method whereby receipts are separately scheduled.

(2) The separate Cash Book column method, whereby two separate columns are used, one for receipts from old debtors and another for receipts from new debtors.

(3) The separate Ledger column method, whereby two columns are ruled on each side of the Ledger, one for old debts and the receipts therefrom, and another for new debts and the receipts therefrom.

Elimination Process where All Assets and Liabilities are not Taken Over. The identical problem in connection with the opening entries of a purchaser will apply in a limited company where part only of the assets are acquired, but *all* the assets and liabilities —including those not taken over—remain in the books. A Vendor Account will be opened and debited with the purchase price payable

to the vendor, and except for the fact that the capital introduced into the purchasing company's business will appear in the form of share capital will be dealt with as illustrated in connection with Partnership Accounts—see page 645.

Illustration. The Balance Sheet of B was—

	£		£
Capital	*1,000*	Sundry Assets	1,050
Bank Overdraft	*200*	Stock	100
Creditors	250	*Debtors*	*300*
	£1,450		£1,450

B, Ltd., a new company, agrees to acquire the above business, taking over assets, except debtors, and liabilities except bank overdraft, the purchase consideration being £1,230. Show the opening entries in Ledger form, assuming that the same books are continued. B subscribes £1,500 to the new company, and is allotted 1,500 shares of £1 each fully paid.

[The items in italics are the "eliminating" accounts.]

Dr. CASH *Cr.*

		£			£
To Share Capital		1,500	By Vendor		1,230
			,, Balance	c/d	270
		£1,500			£1,500
To Balance	b/d	270			

Dr. VENDOR *Cr.*

		£			£
To Cash		1,230	By B Capital		1,000
,, Debtors		300	,, Bank		200
			,, Goodwill		830
		£1,530			£1,530

Dr. SHARE CAPITAL *Cr.*

					£
			By Cash		1,500

Dr. B. CAPITAL *Cr.*

		£			£
To Vendor		1,000	*By Balance*	b/d	*1,000*

Dr. BANK *Cr.*

		£			£
To Vendor		200	*By Balance*	b/d	*200*

Dr.			CREDITORS		*Cr.*
					£
			By Balances . . .	b/d	250

Dr			DEBTORS		*Cr*
		£			£
To Balances . .	b/d	300	By Vendor . . .		300

Dr.			SUNDRY ASSETS		*Cr*
		£			
To Balances . .	b/d	1,050			

Dr.			STOCK		*Cr.*
		£			
To Balance . . .	b/d	100			

Dr.			GOODWILL		*Cr.*
		£			
To Vendor . . .		330			

As a result of the above entries, the immediate position is as follows—

	Dr.	*Cr.*
	£	£
Cash	270	
Share Capital		1,500
Creditors		250
Sundry Assets	1,050	
Stock	100	
Goodwill [1]	330	
	£1,750	£1,750

Where the new company is not to take over debtors—as in the preceding illustration—but nevertheless is to COLLECT them as agent for the vendor, it is clear that the asset cannot be struck out by an eliminating entry in the ordinary way, because the Debtors' Accounts must be continued as usual; yet Vendor must be debited, as the debts are not *acquired* by the purchasing company. This situation is met by the following entry—

Debit Vendor [as before].

Credit Debtors' *Suspense* [instead of debtors].

The effect of this is that the Vendor Account is properly adjusted, and although the debtors' balances formally remain in the books, they are offset by the Debtors' Suspense Account. The foregoing Trial Balance would be exactly as shown, with the addition of a debit for debtors of £300 and a credit for Debtors' Suspense Account of £300.

[1] See footnote on page 913.

When the £300 is collected, cash will be debited and debtors credited; Debtors' Suspense Account debited and vendor credited. The result will be to clear the original Debtors' Accounts and the Debtors' Suspense Account, leaving £300 due to vendor.

These principles may have to be applied to questions which embody other distinct principles, e.g. where the assets taken over are to be revalued or where complicated capital adjustments between the vendor partners arise. The following example is illustrative of this type of problem.

Illustration. The Balance Sheet of A and B, who share profits 3 : 2 and are entitled to interest on capital at 5 per cent per annum, is as follows—

BALANCE SHEET

		£		£
Creditors		800	Sundry Assets . . .	4,100
Capitals—			Debtors	1,200
A . .	£3,200		Investments . . .	700
B . .	2,000			
		5,200		
		£6,000		£6,000

They decide to convert their business to a limited company, the sole shareholders to be A and B. The purchase agreement provides—

(1) That the debtors, investments, and creditors are not to be taken over, but the debtors collected and the creditors paid out of such proceeds by the company as agents for the firm.

(2) That the purchase consideration is £5,000, to be settled in 4,000 5 per cent preference shares of £1 each fully paid and the balance in ordinary shares of 10s. each fully paid in the new company.

In addition to the above, A and B subscribe equally for 500 preference shares and 1,000 ordinary shares.

The same books are employed by the new company, the latter revaluing the assets taken over at £4,300.

Show Ledger entries relative to the above in the books of the limited company, ignoring preliminary expenses.

Dr. CREDITORS *Cr.*

						£
				By Balances . . .	b/d	800

[1] Goodwill is arrived at as follows—

	£	£
Purchase Consideration . . .		1,230
Less Net Assets, i.e.—		
Sundry Assets	1,150	
Less Creditors . . .	250	
		900
Goodwill . . .		£330

Dr. SUNDRY ASSETS *Cr.*

		£				
To Balances . . .	b/d	4,100				
,, Vendors—Appreciation of Assets . . .		200				

Dr. INVESTMENTS *Cr.*

		£				£
To Balance . . .	b/d	700		By Vendors . . .		700

Dr. CAPITALS[1] *Cr.*

		A	B			A	B
		£	£			£	£
To Vendors .		3,200	2,000	By Balances .	b/d	3,200	2,000

Dr. VENDORS[1] *Cr*

		£			£
To Debtors' Suspense Account . . .		1,200	By Creditors' Suspense Account . . .		800
,, Investments . .		700	,, Capital Accounts—		
,, Preference Share Capital Account . . .		4,000	A . . .		3,200
,, Ordinary Share Capital Account . .		1,000	B . . .		2,000
			,, Appreciation of Assets .		200
			,, Goodwill Account . .		700
		£6,900			£6,900

Dr. DEBTORS *Cr.*

		£				
To Balances . . .	b/d	1,200				

Dr. GOODWILL *Cr.*

		£				
To Vendors . .		700				

Dr. CASH *Cr*

		£				
To Preference Share Capital Account . . .		500				
,, Ordinary Share Capital Account . . .		500				

Dr. DEBTORS' SUSPENSE *Cr*

						£
				By Vendors . . .		1,200

[1] The Capital Accounts and the contents of the Vendors' Account may be merged in one account, the transfers of £3,200 and £2,000 then being unnecessary.

Dr. CREDITORS' SUSPENSE *Cr.*

	To Vendors	£ 800				

Dr. SHARE CAPITALS *Cr.*

					Preference	Ordinary
				By Vendors „ Cash	£ 4,000 500	£ 1,000 500

The amount of goodwill is the excess of the purchase consideration £5,000 over the value of the assets as revalued at £4,300.

The Trial Balance will now be—

TRIAL BALANCE

		Dr.	*Cr.*
		£	£
	Creditors		*800* (1)
(5)	Goodwill	700	
(6)	Sundry Assets	4,300	
(7)	Debtors	1,200	
	Preference Share Capital		4,500 (2)
	Ordinary Share Capital		1,500 (3)
(8)	*Creditors' Suspense*	*800*	
(9)	Cash	1,000	
	Debtors' Suspense		1,200 (4)
		£8,000	£8,000

The opening Journal entries if new books had been opened in the ordinary way would, ignoring narratives, be as follows—

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			£	£
(5)	Goodwill	*Dr.*	700	
(6)	Sundry Assets	*Dr.*	4,300	
(7)	Debtors	*Dr.*	1,200	
(8)	Creditors' Suspense	*Dr.*	800	
	To Debtors' Suspense			1,200 (4)
	„ Creditors			800 (1)
	„ Vendors			5,000
	Vendors	*Dr.*	5,000	
	To Preference Share Capital			4,000 (2)
	„ Ordinary Share Capital			1,000 (3)
(9)	Cash	*Dr.*	1,000	
	To Preference Share Capital			500 (2)
	„ Ordinary Share Capital			500 (3)

The numbers in parenthesis refer to the appropriate items in each set of figures.

The results arising from the foregoing Journal entries are precisely the same as those disclosed in the Trial Balance on page 915.

Illustration. The Trial Balance of P, Ltd., on 31st December, 1953, is as follows—

TRIAL BALANCE, 31ST DECEMBER, 1953

	Dr.	Cr.
	£	£
V. Capital		8,250
Sundry Assets	10,300	
Sundry Liabilities		1,400
Profit and Loss Account		650
	£10,300	£10,300

The purchase consideration was £13,500, payable in 12,500 shares of £1 each, fully paid, and £1,000 in cash. The date from which the new company was to take over was 1st January, 1953. The debtors and creditors at that date were £3,000 and £1,200, which were not taken over but collected, and out of the proceeds the liabilities paid by the new company, the balance being paid to the vendor. No entries had been made in respect of the above transactions, except that the vendor had been debited with £1,000 paid to him in part discharge of the purchase consideration, and £1,750 out of the £1,800 due on debt collection after payment of creditors.

As on 1st January, 1953, the assets taken over were reduced in value by £700.

Show adjusting entries in Journal form, ignoring narratives and interest, and assuming that all the debts and liabilities of the vendor have been paid; and prepare new Trial Balance.

The Capital Account of the vendor *before* the payments of £1,000 and £1,750 was £11,000, so that the net assets acquired were £9,200, as follows—

	£	£
Capital		11,000
Less Debtors	3,000	
Less Creditors	1,200	
		1,800
Net Assets		£9,200

The purchase price being £13,500, Goodwill would, but for the adjustment of £700 in respect of sundry assets, be £4,300, but the latter sum must be *increased* to £5,000, and the sundry assets reduced by £700.

The adjusting entries, ignoring narratives, are—

		£	£
Goodwill	Dr.	5,000	
To Sundry Assets			700
„ Vendor			4,300
Vendor	Dr.	12,500	
To Share Capital			12,500

The Vendor's Account is—

VENDOR

Dr.		£	Cr.		£
To Cash		1,000	By Balance	b/d	11,000
" "		1,750			
" Balance (per question)	c/d	8,250			
		£11,000			£11,000
To Share Capital Account		12,500	By Balance	b/d	8,250
" Balance	c/d	50	" Goodwill		4,300
		£12,550			£12,550
			By Balance	b/d	50

The balance still remaining in favour of the vendor represents the excess of collections (£3,000) over payments to creditors (£1,200), and to vendor (£1,750).

The Trial Balance will now be—

TRIAL BALANCE, 31ST DECEMBER, 1953

	£	£
Vendor		50
Sundry Assets [£10,300–£700]	9,600	
Sundry Liabilities		1,400
Profit and Loss Account		650
Goodwill	5,000	
Share Capital		12,500
	£14,600	£14,600

If the Debtors' and Creditors' Suspense Accounts had been opened, they would have appeared as follows—

DEBTORS' SUSPENSE

Dr.	£	Cr.	£
To Vendor (Collection) Account	3,000	By Vendor	3,000

CREDITORS' SUSPENSE

Dr.	£	Cr.	£
To Vendor	1,200	By Vendor (Collection) Account	1,200

The Vendor's Accounts would appear thus—

VENDOR (PURCHASE OF BUSINESS)

Dr.	£	Cr.		£
To Debtors' Suspense Account	3,000	By Balance	b/d	11,000
" Cash	1,000	" Creditors' Suspense Account		1,200
" Share Capital Account	12,500	" Goodwill		4,300
	£16,500			£16,500

Dr. VENDOR (COLLECTION) Cr.

		£			£
To Creditors' Suspense Account (cash paid)		1,200	By Debtors' Suspense Account (cash collected)		3,000
,, Cash		1,750			
,, Balance	c/d	50			
		£3,000			£3,000
			By Balance	b/d	50

[The cash received from debtors and paid to creditors will be entered in the Cash Book and posted to the personal accounts in the ordinary way.]

Construction of Acquisition Entries. Examination papers frequently include complicated questions on the entries relative to acquisition of assets by a company; and no length of textual explanation can be an effective substitute for the practical exposition of the procedure required. In order to assist the student three typical problems are set out and worked through.

Illustration. Coome & Co. sold their business on 15th January, 1953, to Martin, Ltd., the latter being incorporated on that date. The purchaser is to take over as and from 1st January, 1953, at which date the assets comprised the following—

	£
Buildings	3,000
Fixtures	670
Debtors	4,200
Stock	1,800
Bank	700
Creditors	1,300
Rates prepaid	30

The purchase agreement contained the following material clauses—

(1) The creditors are to be *paid* by the vendors.

(2) The trade debtors and bank balance are to be *retained* by the vendors, but the purchasers are to collect the debtors for a commission of 5 per cent on cash collected.

(3) The purchase consideration is to be £7,000, to be discharged by (*a*) a cash payment of £1,000; (*b*) an allotment of 3,000 preference shares of £1 each fully paid; and (*c*) an allotment of 4,000 ordinary shares of £1 each 15s. paid; the amounts collected (less commission) to be applied at the end of December, 1953, in making the ordinary shares fully paid, the balance over (if any) to be paid to the vendors on the same date.

The company issued 5,000 8 per cent £1 preference shares at a premium of 2s., and, in addition, by the end of December the shares were called to the extent of 15s. One preference shareholder holding 400 had paid all his calls in advance, whilst a shareholder with 600 was in arrear for the previous call of 2s.

The general expenses included £200 for underwriting commission, which was discharged by the issue of 200 ordinary shares of £1 each fully paid at par, with an option to purchase a further

250 ordinary shares of £1 each at 25s. within the next three years.[1]

The cash collected by the company on behalf of the vendors was £2,300; discounts allowed, £100.

The following balances, apart from those from the foregoing matters, were shown in the books of Martin, Ltd., on 31st December, 1953.

		£
Purchases		20,430
Sales		24,090
Purchases Returns		320
Discounts (on *all* Debtors)		400
Preliminary Expenses		100
General Expenses		1,410
Rates (on account of the year to 31st March, 1954, of £120—same as the previous year)		100
Debtors (New and *Old*)		7,300
Creditors		2,180
Cash	*Dr.*	3,355
		£59,685

Prepare Trial Balance at 31st December, 1953.

Solution. Several involved entries are necessary before any attempt can be made at constructing the Trial Balance; but the student must be particularly careful to avoid altering the cash balance, as this is the true balance. In other words, the entries in respect of cash have *already* been recorded.

Ascertainment of Goodwill—

		Dr.	*Cr.*
		£	£
(*a*)	Goodwill (balancing figure)	1,500	
(*b*)	Buildings	3,000	
(*c*)	Fixtures	670	
	Debtors	4,200	
(*d*)	Stock	1,800	
(*e*)	Rates Prepaid	30	
	Debtors' Suspense		4,200
	Vendors		7,000
		£11,200	£11,200

Items marked (*a*), (*b*), (*c*), (*d*), and (*e*) will appear as above in the Trial Balance.

The item of debtors will be superseded by the closing debtors as shown in the list of balances.

As previously explained, the vendor will finally be credited with cash collected, and the debtors reduced by the cash and discount (the balances remaining being included in the end balances of debtors already shown in the list of balances).

Accordingly, the figure of Debtors' Suspense (£4,200) will be reduced by £2,400 (i.e. cash collected £2,300, plus discounts allowed £100), leaving £1,800 for the Trial Balance. Consequently the

[1] This option must be noted on the Balance Sheet (see pages 790–1).

vendors become creditors for £2,300, the difference of £100 being accounted for by the debit to the vendors for discounts allowed, but of this credit, £2,300, the sum of £115 is the commission to the purchaser for the collection, leaving £2,185 finally due to the vendors and £115 to be credited to Commission Account. As the question indicates, the balance at the end of the year due to the vendors is to be applied (1) to make the ordinary shares allotted fully paid (upon which 15s. per share has been credited as per the vending agreement); and (2) final balance to be paid in cash to the vendors.

The sum of £2,185 will be disposed of as follows—

(1) 4,000 at 5s. (to bring the Ordinary Shares of 15s. called and paid to £1 fully paid)	= £1,000 [to be shown in Trial Balance] Ordinary Share Capital.
(2) Balance to Vendors	= £1,185 which already having been paid, will not be shown in the Trial Balance as its effect is to reduce the cash balance, and the ACTUAL cash balance at 31st Dec., 1953, is shown in the list of balances.

As a result, therefore, of these adjustments, the following will appear in the Trial Balance—

			£
	(*f*) Debtors' Suspense	*Cr.*	1,800
	(*g*) Commission	*Cr.*	115
(see below)	(*k*) Ordinary Share Capital . .	*Cr.*	1,000

It will be noticed that of the original credit item of £4,200 appearing in Debtors' Suspense Account, the combined sum of £2,915 (*f.g.k.*) has been accounted for, the difference of £1,285 being made up of (1) cash paid as above, £1,185, and (2) Discounts Account credited, £100 (not being the purchasing company's loss).

The amount of £7,000 has been discharged in cash, £3,000 in preference shares and £3,000 in ordinary shares (i.e. 4,000 ordinary shares of £1 each, 15s. paid).

Share Capital and Premiums. 5,000 preference shares at a premium of 2s. are called up to the extent of 15s., so that the preference share capital will appear—

	£		£
(*h*) 5,000 Preference Shares at 15s. . . .	3,750		
(*i*) Vendors' Shares (as above), 3,000 at £1 .	3,000		
	——	*Cr.*	6,750
(*j*) Premium on Shares, 5,000 at 2s. . . .		*Cr.*	500
(*k*) 4,000 Ordinary Shares at 15s.	3,000		
Plus Amounts collected, applied as above	1,000		
	——	*Cr.*	4,000

In addition, a shareholder with 400 Preference Shares has paid all his calls in advance, all of which will have been duly absorbed

save the last call of 5s., so that he is a creditor for 400 at 5s. = £100. Further, there are calls in arrear of 600 at 2s. = £60.

Hence, the Trial Balance must include the above, viz.—

		£	£
(*l*) Calls in advance	*Cr.*		100
(*m*) Calls in arrear	*Dr.*	60	

There has been incurred an expense of £200 (included in the balances presented) discharged by an allotment of ordinary shares of £1 each fully paid, the latter only requiring insertion into the Trial Balance, thus—

		£
(*n*) Ordinary Share Capital . .	*Cr.*	200

[The amount of £200 included in general expenses must be separated and shown in Balance Sheet till written off.]

Lastly, as the discount includes the sum of £100, which properly is chargeable to the vendors, there must be a credit inserted therefrom, and entered in the Trial Balance.

		£
(*o*) Discounts Account . . .	*Cr.*	100

The figures in the list may now be totalled, to which will be added the accounts lettered (*a*–*o*) in the preceding paragraphs.

TRIAL BALANCE, 31ST DECEMBER, 1953

		Total	Debits	Credits
	£	£	£	£
Total per List		59,685		
Less Credits—				
Sales	24,090			
Purchases Returns	320			
Creditors	2,180	26,590	33,095	26,590
	Debits	Credits		
Plus (*a*) Goodwill	1,500			
(*b*) Buildings	3,000			
(*c*) Fixtures	670			
(*d*) Stock	1,800			
(*e*) Rates	30			
(*f*) Debtors' Suspense . . .		1,800		
(*g*) Commission		115		
(*h*) Preference Share Capital . .		3,750		
(*i*) Preference Share Capital (Vendors)		3,000		
(*j*) Premium on Preference Shares .		500		
(*k*) Ordinary Share Capital (Vendors)		4,000		
(*l*) Calls in Advance . . .		100		
(*m*) Calls in Arrear	60			
(*n*) Ordinary Share Capital (Underwriters)		200		
(*o*) Discounts		100		
	£7,060	£13,565	7,060	13,565
			£40,155	£40,155

The process of preparing final accounts calls for no comment, save that there will be required an adjustment for profit prior to incorporation, and the underwriting commission must be shown separately in the Balance Sheet.

The following illustration is somewhat involved, and requires a thorough knowledge of the principles outlined and a capacity to adapt them to the particular circumstances.

Examination Problem

A and B were partners sharing profits and losses in the ratio of 20 : 17, and closed their books yearly at 31st December.

On 1st May, 1953, A & B, Ltd. was incorporated to acquire the above business as and from 1st January, 1953.

The purchase agreement provides—

(1) Purchase consideration: 6,000 preference shares, £1 each fully paid; 2,400 ordinary shares, 5s. each fully paid.

(2) Vendors to retain cash, and to entrust the company with the collection of debtors and the discharge of creditors, any balance till final clearance to be retained in a separate account.

(3) Each of the vendors to subscribe in cash for one-half of the balance of the authorized capital, 850 preference shares and 200 ordinary shares.

The Articles of Association appoint A and B sole directors, with fees of £100 per month each.

The accounts have been continued in the books without a break since 1st January, 1953, and no entries arising from the formation of the company or its acquisition of the business have been made.

Ignoring tax, prepare final accounts to the 30th September, 1953, from the following Trial Balance and information—

Trial Balance	Dr.	Cr.
	£	£
A: Capital on 1st January, 1953		3,000
B: Capital on 1st January, 1953		2,860
A: Drawings during Year	250	
B: Drawings during Year	300	
A and B *re* Shares		900
Buildings	3,800	
Creditors (£1,500 owing at 1st January, 1953, ALL paid)		700
Debtors (£1,000 due at 1st January, 1953, £100 still outstanding)	1,050	
Preliminary Expenses	150	
Plant and Machinery (Balance at 1st January, 1953, £1,200)	1,500	
Furniture and Fittings (Balance at 1st January, 1953, £360)	460	
Purchases and Sales	2,000	8,200
Wages [charge to Trading Account]	800	
Stock	500	
Bank (Balance at 1st January, 1953, £500)	3,500	
Sundry Expenses	1,350	
	£15,660	£15,660

A and B agree to take the preference shares for their capitals at 1st January, 1953.

The average of the monthly sales (the company sells a commodity at a fixed price) for the first four months of 1953 was one-half that of the remainder of the period, and the expenditure each month on items in the Profit and Loss Account was constant.

Write off £72 depreciation from plant and machinery, and all the preliminary expenses. Stock at 30th September, 1953, is valued at £700.

In addition to preparing final accounts, show (1) the Journal entries necessary to put the books in order; and (2) the respective shareholdings of the vendor partners.

(*Adapted from Institute of Chartered Accountants' Final.*)

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		£	£
1953 May 1	Capital—A . . . . . . Dr.	3,000	
	B . . . . . . Dr.	2,860	
	To Purchase of Business Account .		5,860
	Being transfer of capitals at 1st January, 1953.		
	Goodwill . . . . . Dr.	740	
	To Purchase of Business Account .		740
	Being cost of goodwill of business acquired.		
	Purchase of Business Account . . Dr.	6,600	
	To Preference Share Capital . .		6,000
	,, Ordinary Share Capital . .		600
	Being issue of shares [detailed] in satisfaction of purchase price as per agreement.		
	A and B . . . . . . Dr.	900	
	To Preference Share Capital . .		850
	,, Ordinary Share Capital . .		50
	Being issue of shares [detailed] per cash received and allotments made.		
Sept. 30	Vendors[1] . . . . . . Dr.	100	
	To Debtors' Suspense . . .		100
	Being adjustment for firm debtors not taken over still remaining in books.		

[The following redrafted Trial Balance—arising from the Journal entries and postings—would in examination work be superimposed upon the examination paper Trial Balance, as time would not permit of the slightest unnecessary writing.]

[1] See Note 2, page 926.

REDRAFTED TRIAL BALANCE, 30TH SEPTEMBER, 1953

	Dr. £	Cr. £
A: Capital		***
B: Capital		***
A: Drawings	250	
B: Drawings	300	
A and B *re* Shares		***
Buildings	3,800	
Creditors		700
Debtors	1,050	
Preliminary Expenses . . .	150	
Plant and Machinery	1,500	
Furniture and Fittings . . .	460	
Purchases and Sales	2,000	8,200
Wages	800	
Stock	500	
Bank	3,500	
Sundry Expenses	1,350	
Goodwill	*740*	
Preference Share Capital . . .		*6,850*
Ordinary Share Capital . . .		*650*
Vendors	*100*	
Debtors' Suspense		*100*
	£16,500	£16,500

Note. The asterisks *** represent original accounts that have now disappeared, the new items being in italics.

The next step is to proceed to the final accounts, dealing carefully with directors' fees (against which the withdrawals of A and B will be debited) and the question of profit prior to incorporation, leaving the apportionment of shareholding of preference shares (£6,850) and ordinary shares, £650 (2,600 of 5s. each), till the last.

Note. The profit is apportioned on a "turnover" basis, as clearly indicated in the question. The question in effect states that the turnover in each of the first four months is half that in the following five months, so that the respective ratios of TOTAL turnover may be very simply computed by assuming sales for *each* month in the pre-incorporation period to be *one* unit, in which case the sales for each month in the post-incorporation period will be *two* units. Hence the total turnover in the two periods is—

	Months		Units			Fractions
Pre-incorporation period .	4	×	1	=	4	$\frac{4}{14}$
Post-incorporation period .	5	×	2	=	10	$\frac{10}{14}$
					14	

Trading and Profit and Loss Account for the Nine Months Ended 30th September, 1953

Dr.		£	£	*Cr.*	£	£
To Stock			500	By Sales		8,200
,, Purchases			2,000	,, Stock		700
,, Wages			800			
,, Gross Profit c/d			5,600			
			£8,900			£8,900
		Pre-Incorporation [4 mos.]	Post-Incorporation [5 mos.]		Pre-Incorporation [4 mos.]	Post-Incorporation [5 mos.]
To Expenses	£1,350			By Gross Profit b/d	($\frac{2}{7}$) 1,600	($\frac{5}{7}$) 4,000
,, Depreciation	72					
	£1,422	632	790			
,, Directors' Fees			1,000			
,, Preliminary Expenses[1]			150			
,, Capital Reserve		968				
,, Net Profit			2,060			
		£1,600	£4,000		£1,600	£4,000

Balance Sheet as at 30th September, 1953

	£	£		£	£
Capital and Surplus:			*Fixed Assets* at cost:		
Share Capital, Authorized and Issued:			Buildings		3,800
6,850 Preference Shares of £1 each, fully paid	6,850		Plant and Machinery	1,200	
2,600 Ordinary Shares of 5s. each, fully paid	650		*Add* Purchases	300	
		7,500		1,500	
			Less Depreciation	72	
					1,428
Capital Reserve		968	Furniture and Fittings		460
Profit and Loss Account		2,060	Goodwill		740
					6,428
		10,528	*Current Assets:*		
Current Liabilities:			Stock	700	
Trade Creditors	700		Sundry Debtors £1,050		
Directors' Fees (see note 1)	450		*Less* Debtors' Suspense Account 100		
		1,150		950	
			Vendor (see note 2, page 926)	100	
			Cash at Bank	3,500	
					5,250
		£11,678			£11,678

Notes. (1) This is arrived at by the £1,000 (debited to Profit and Loss Account) *less* the debit of drawings of £550 (in Trial Balance), the respective accounts being—

	A	B	Total
	£	£	£
Directors' Fees for *five* mos. @ £100 per mo.	500	500	1,000
Less Drawings	250	300	550
Cr. Balances	£250	£200	£450

[1] More accurately to the Appropriation Account.

(2) The Suspense Accounts would be opened at the date of taking over but as the amount due to the Vendors (Bank £500 and Debtors £1,000) and due from Vendors (Creditors £1,500) are equal and have been cleared up save for the balance of Debtors £100, an entry is made for the latter item only.

The allocation of share capital will be thus—

	A	B	Total
	£	£	£
Capital	3,000	2,860	5,860
Profit on Sale [divided 20 : 17] .	400	340	740
Cash Subscribed . . .	450	450	900
Total to be allotted .	£3,850	£3,650	£7,500

PREFERENCE SHARES

	A	B	Total
	£	£	£
Capital	3,000	2,860	5,860
Cash Application	425	425	850
Balance in Profit and Loss ratio [20: 17] to make up total Preference Share Capital [to nearest whole number] .	76	64	140
Total	£3,501	£3,349	£6,850

ORDINARY SHARES

	A				B				Total			
	No	£	s	d	No	£	s	d	No.	£	s.	d
Cash Application	100	25	0	0	100	25	0	0	200	50	0	0
Balance in Profit and Loss ratio to make up total Ordinary Share Capital [to nearest whole number] . . .	1,297	324	5	0	1,103	275	15	0	2,400	600	0	0
Total	1,397	£349	5	0	1,203	£300	15	0	2,600	£650	0	0

SUMMARY

	A						B						Total					
	£	s	d	£	s	d	£	s	d.	£	s	d	£	s	d	£	s	d.
Total Amount due . .				3,850	0	0				3,650	0	0				7,500	0	0
Allotments in £'s—																		
Preference Shares .	3,501	0	0				3,349	0	0				6,850	0	0			
Ordinary Shares .	349	5	0	3,850	5	0	300	15	0	3,649	15	0	650	0	0	7,500	0	0
Balance, settled in Cash	[due *from* A]				5	0	[due *to* B]				5	0				—	—	—

With regard to the allotment of ordinary shares, the obviously practical method would be to allot (apart from the cash subscriptions)—

A: 1,300 shares of 5s. = £325 instead of 1,297 shares of 5s. each
= £324 5s.
B: 1,100 shares of 5s. = £275 instead of 1,103 shares of 5s. each
= £275 15s.

This would entail a further payment by A to B for three "extra" shares of 5s. = 15s., leaving a final adjustment of £1 in cash.

In the latter event, in order to preserve round numbers of shares, A would be allotted 3,500 instead of 3,501 preference shares, and B 3,350 instead of 3,349 preference shares, the division of shares being thus—

	A		B	
	No.	£	No.	£
Preference Shares . .	3,500	3,500	3,350	3,350
Ordinary Shares . .	1,400	350	1,200	300
Total . . .		£3,850		£3,650

The above allocation will avoid any cash payment between A and B, as the former will receive one preference less than the allocation shown on page 926 instead of paying B £1.

Illustration. On 1st January, 1953, A sells his business to Jones, Ltd., the latter taking over all assets and liabilities, the purchase consideration being £3,000 payable equally in cash and shares of £1 each fully paid. A sum of £500 on account has been paid to A during the year ended 31st December, 1953, but no other entries have been made.

A's Balance Sheet, at the time of the sale, was as follows—

BALANCE SHEET AS AT 1ST JANUARY, 1953

	£		£
Creditors	900	Sundry Fixed Assets . .	1,500
Capital	2,200	Debtors	1,400
		Stock	200
	£3,100		£3,100

Sundry Fixed Assets are to be revalued at £1,270.

In addition to the matters arising out of the above, there are the following balances in the books of Jones, Ltd., at 31st December, 1953—

BALANCES	£
Share Capital	5,000
A (Vendor)	1,700
Debtors	1,250
Sundry Fixed Assets	1,500
Stock	200
Purchases	4,800
Sales	5,300
Creditors	430
Cash in Bank	4,680

Prepare Trial Balance at 31st December, 1953.

TRIAL BALANCE

		Dr. £	Cr. £
Goodwill		1,030	
Share Capital			6,500
A (Vendor)	[1]		1,000
Debtors		1,250	
Sundry Fixed Assets		1,270	
Stock		200	
Purchases		4,800	
Sales			5,300
Creditors			430
Bank		4,680	
		£13,230	£13,230

The necessary adjusting entries would be—

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			£	£
1953 Jan. 1	Goodwill . . . . . . *Dr.*		1,030	
	To Sundry Fixed Assets			230
	,, Vendor			800
	Being adjustment of accounts in accordance with purchase agreement dated . . . ., and revaluation of fixed assets.			
	Vendor . . . . . . *Dr.*		1,500	
	To Share Capital			1,500
	Being allotment of 1,500 shares of £1 each fully paid to vendor, in part discharge of liability to him as per directors' resolution dated . . . . *vide* Minute Book, p. . . .			

General Illustration. On 1st January, 1953, Denison Trackless Tramways, Ltd., purchased 20,000 shares of Anson Electric Tramways, Ltd., at 18s. a share.

The Balance Sheet of the latter company at 31st December, 1952, was as follows—

[1] A is still a creditor for £1,000 to be paid in cash.

BALANCE SHEET AS AT 31ST DECEMBER, 1952

	£		£
Share Capital (£1)	25,000	Sundry Assets	32,000
Profit and Loss Account	1,000	Other Assets	7,000
Debentures	10,000		
Creditors	3,000		
	£39,000		£39,000

On 1st February, 1953, the chief assets of Anson Electric Tramways, Ltd. (described in the Balance Sheet as "Sundry Assets"), were purchased by Denison Trackless Tramways, Ltd., for £26,000, to be discharged on 1st March, 1953, as follows: £16,000 in cash and the taking over of the liability to the Debenture holders £10,000, subject to the power of purchasing any of the Debentures in the open market not later than 30th April, 1953. £3,000 and £2,000 of Debentures were purchased on the 1st April, 1953, and the 30th April, 1953, respectively for cancellation. The respective prices per £100 were £101 and £98. The Debenture holders had the option of receiving in exchange either Shares or Debentures of Denison Trackless Tramways, Ltd. By the 15th May, 1953, holders of £2,500 Debentures of Anson Electric Tramways, Ltd., decided to accept Shares, and the remainder decided to accept Debentures, all at par.

On 1st May, 1953, Anson Electric Tramways, Ltd., went into liquidation, the liquidator realizing the remaining assets (described in the Balance Sheet as "Other Assets") for £5,000. The expenses of liquidation were £500.

The property acquired was converted into a trackless system at a cost of £7,000 before crediting £3,000 for sale of old materials. The former was complete on 31st May, 1953, the sale of old materials taking place on 15th February, 1953.

Ignoring income tax, stamp duties, and interest, write up the Ledger accounts of the aforesaid companies in respect of the above transactions.

The dates in the books of Anson Electric Tramways, Ltd., are to be ignored and the whole of the realization items shown in one account.

Books of Anson Electric Tramways, Ltd.

Dr. REALIZATION ACCOUNT *Cr.*

		£			£
To Sundry Assets		32,000	By Debentures taken over	[1]	10,000
,, Other Assets		7,000	,, Denison Trackless Tramways, Ltd.: Purchase Consideration	[1]	16,000
,, Realization Expenses		500	,, Cash: Sale of other Assets		5,000
			,, Loss on Realization		8,500
	£	39,500		£	39,500

[1] Alternatively, (i) Debit Denison Trackless Tramways, Ltd., £26,000.
Credit Realization Account, £26,000.
(ii) Debit Debentures, £10,000
Credit Denison Trackless Tramways, Ltd., £10,000.

Dr. DENISON TRACKLESS TRAMWAYS, LTD. Cr.

			£				£
	To Realization Account: Purchase Consideration . . .		16,000		By Cash . . .		16,000

Dr. CASH Cr.

			£				£
	To Denison Trackless Tramways, Ltd. .		16,000		By Realization Expenses		500
	,, Realization Account: Sale of other Assets		5,000		,, Creditors . . .		3,000
					,, Sundry Members [1] .		17,500
		£	21,000			£	21,000

Dr. SUNDRY MEMBERS Cr.

			£				£
	To Realization Account: Loss on Realization		8,500		By Share Capital Account		25,000
	,, Cash . . .		17,500		,, Profit and Loss Account . . .		1,000
		£	26,000			£	26,000

Books of Denison Trackless Tramways, Ltd.

Dr. ANSON ELECTRIC TRAMWAYS, LTD., SHARES Cr.

			£				£
1953 Jan. 1	To Cash: 20,000 Shares at 18s. . . .		18,000	1953 May 31	By Cash: First and Final Return from Liquidator . . .		14,000
					,, Property Account .		4,000
		£	18,000			£	18,000

Dr. ANSON ELECTRIC TRAMWAYS, LTD., PROPERTY Cr.

			£				£
1953 Feb. 1	To Anson Electric Tramways, Ltd., Vendor Account . .		26,000	1953 Feb. 15	By Cash: Sale of Old Materials[2] . .		3,000
				May 15	,, Anson Electric Tramways, Ltd., Debenture-holders' Account . . .		10
				31	,, Property Account .		22,990
		£	26,000			£	26,000

Dr. ANSON ELECTRIC TRAMWAYS, LTD., VENDOR Cr.

			£				£
1953 Mar. 1	To Cash . . .		16,000	1953 Feb. 1	By Anson Electric Tramways, Ltd., Property Account .		26,000
	,, Anson Electric Tramways, Ltd., Debenture-holders' Account		10,000				
		£	26,000			£	26,000

[1] I.e. 14s. in £ on 25,000 shares.
[2] See note 2 on page 931.

Dr. ANSON ELECTRIC TRAMWAYS, LTD., DEBENTURE-HOLDERS **Cr.**

			Nominal £	£					£
1953 Apr. 1	To Cash: Debentures purchased at 101		3,000	3,030	1953 Mar. 1	By Anson Electric Tramways, Ltd. Vendor Account			10,000
30	,, Do. 98		2,000	1,960					
May 15	,, Share Capital		2,500	2,500					
	,, Debentures		2,500	2,500					
	,, Anson Electric Tramways, Ltd. Property Account: Profit on purchase of Debentures .			10					
			£10,000	£10,000					£10,000

Dr. PROPERTY **Cr.**

			£				£
1953 May 31	To Anson Electric Tramways, Ltd.: Cost of acquisition of property . . .		22,990	1953 May 31	By Balance	c/d	33,990
	,, Anson Electric Tramways, Ltd.: Loss on liquidation . .	1	4,000				
	,, Conversion Costs from Electric Rail to Trackless . .	2	7,000				
		£	33,990			£	33,990
June 1	To Balance	b/d	33,990				

[1] Alternatively, the item of £4,000 may be debited to Goodwill Account, as this represents the excess of purchase price over the valuation of the assets (assuming that the item "Sundry Assets" does not already include a figure for Goodwill).

This may be seen by comparing the cost of the assets acquired with the valuation of £26,000.

	£
Cost of acquisition—	
Cost of Shares	18,000
Less received on liquidation, 14s. in £ on 20,000 Shares	14,000
Balance	£4,000

The item of £4,000 reconciles with the loss on realization on assets of Anson Electric Tramways, Ltd., as follows—

	£
Loss on realization	8,500
Less credit balance of Profit and Loss Account	1,000
Net Loss to Members	£7,500

	£
80% thereof	6,000
Less "profit" on purchase of shares [£20,000 – £18,000]	2,000
	£4,000

The cost of conversion may be capitalized (*even* if the company is not a new one) (*Cox* v. *Edinburgh and District Tramways Co.*).

[2] The net balance of £4,000 [£7,000 – £3,000 (sale of old materials)] may be debited to Property Account.

Dr. DEBENTURES *Cr.*

				1953 May 15	By Anson Electric Tramways, Ltd., Debenture-holders' Account . . .		£ 2,500

Dr. SHARE CAPITAL *Cr.*

				1953 May 15	By Balance . . .	b/d	£ ?
					,, Anson Electric Tramways, Ltd., Debenture-holders' Account . . .		2,500

SECTION (G) DIVISIBLE PROFITS AND FINAL ACCOUNTS

The existence of profits is a necessary factor before a dividend can be paid; in other words, there must be an excess of income over expenditure. The legal requirements (which differ considerably from the accounting requirements) may be summarized thus—

(1) Subject to the undermentioned rules, the Articles must be adhered to, and in the absence of contrary restrictions the directors may make suitable reserves for contingencies and other proper purposes as laid down in Clause 117 of Table A (1948).

(2) There is no need to provide for depreciation on FIXED assets, the authority therefor being contained in the judgment delivered in *Verner* v. *General Commercial Trust.* As a result, "Fixed assets may be sunk and lost, and yet the excess of current receipts over current payments may be divided, but FLOATING or CIRCULATING capital must be maintained."

Provision must be made, however, for the upkeep, that is, the depreciation, of FLOATING assets. (Articles may provide for depreciation of BOTH types of assets.)

(3) The divisible profit of the current year is usually not to be reduced by losses incurred in the past, unless the directors decide otherwise; but regard must be had to the nature of the business, the amount and nature of the loss. (*Ammonia Soda Co.* v. *Chamberlain.*)

(4) Goodwill for the purpose of determination of profits is a FIXED asset. (*Wilmer* v. *McNamara.*)

(5) Profits arising from forfeited shares are available for dividends, unless the Articles FORBID (*Hilder* v. *Dexter*); unless the company has adopted the DOUBLE ACCOUNT System when these profits are irrevocably "Capital," the distribution of which is, notwithstanding Articles, forbidden. (*Wall* v. *London and Provincial Trust.*)

(6) Where goodwill (and probably any other FIXED asset) has been written off, the amount, if reasonable, and if the proceeding is not contrary to the constitution of the company, may be re-credited to Profit and Loss Account, unless it appears that the item has been irrevocably written off. (*Stapley* v. *Read Bros.*)

(7) Where a capital profit has accrued to the company, it is necessary, before such profit is available for dividend, that three conditions shall be fulfilled: (1) The profit must be REALIZED; (2) a surplus must exist after a REVALUATION of ALL assets; (3) there must be nothing in the Articles of the company forbidding such distribution. (In other words, the capital profit, when realized, must be used to write down all assets to their fair value, only the balance remaining being distributable.) These restrictions, however, only apply to CASH dividends, or other releases of ASSETS: a **bonus Share** dividend may be paid out of unrealized profits if the articles permit (*Foster* v. *New Trinidad Lake Asphalte Co.; Lubbock* v. *British Bank of South America*).

(8) The profit in (7) is never available for dividend if it is on an "original" asset (*Foster* v. *New Trinidad Lake Asphalte Co.*).

(9) The requirements appertaining to item (7) do not apply to revenue profits (*City of Glasgow Bank* v. *McKinnon*), that is, they may be ***unrealized***, and no surplus of assets may remain after revaluation.

(10) Profit may be said to be the increase in net assets which has taken place during the period in question, due allowance being made for any capital introduced into or taken out of the business in the meanwhile (*re Spanish Prospecting Co.*).

(11) Whenever the rights of third parties intervene, profit MUST be strictly ascertained, and in the absence of special stipulations ***actual*** profit is to be taken (*re Spanish Prospecting Co.*).

(12) Preliminary expenses may be charged to capital, i.e. retained as a debit balance (*Bale* v. *Cleland*), and shown as such in the Balance Sheet, but the item ***may*** be written off.

(13) It was laid down in *re Crabtree* that *depreciation of* trade machinery must be provided for in ascertaining profit, but this case had reference to the claim of an executor of a partner against the surviving partners, and hence has no bearing on divisible profits of a *limited company*.

(14) Profits, though accrued and earned, may still not be wholly available for, or divisible among, ordinary shareholders, because—

(*a*) The Articles may require an allocation of a proportion to reserve.

(*b*) A proportion may be payable to prior shareholders, including the payment of arrears of cumulative preference dividends or even to "outside" parties, e.g. managers' commission, income bondholders. (See page 936.)

(*c*) A proportion may have to be "laid aside" during the currency of the debenture liability, thus tying up a certain amount of profits for several years; hence these profits are divisible eventually, but not immediately.

(15) Profits from subsidiary companies must not be credited to Profit and Loss Account, unless the profit has been received by way of dividend, nor need losses be debited thereto unless the holding

company has become liable in law for the amount thereof. Profit of a subsidiary arising before acquisition must be credited by the holding company as a Capital Reserve.

(16) It is not compulsory for a company to build up a reserve fund for the replacement of an asset (*Cox.* v. *Edinburgh and District Tramways Co.*).

(17) A distinction must be made between—

(*a*) Trading profits.
(*b*) Net profits.
(*c*) Divisible profits.

Thus (*a*) trading profits usually exclude the increments (less expenses) of a non-trading nature, e.g. capital profits, dividends from companies; but, on the other hand, allocations to reserve, income tax, and capital losses are excluded from the debit.

(*b*) Net profits will include all sources of income less all expenses for the current year, except income tax (which is an appropriation recoupable at the standard rate out of the dividends paid), and other appropriations, e.g. sinking funds built up in connection with redemption of debentures.

(*c*) Divisible profits are net profits reduced by the appropriations above mentioned, less any *debit* balance of previous years if the directors so DECIDE, but usually not otherwise. (See (3) page 932.)

Where directors are entitled to remuneration based upon net profits, it is a matter of construction whether they are entitled to the proportion before or after charging up such remuneration; if "before," it is strictly an appropriation; if "after," a charge, e.g. if the profits are £11,000, the directors being entitled to 10 per cent thereof; if the construction of the agreement requires the remuneration to be on profits remaining after charging such remuneration, the amount is $\frac{1}{11} \times$ £11,000 = £1,000 (leaving net profits "after" £10,000), this being a *charge*. Otherwise the directors are entitled to $\frac{1}{10} \times$ £11,000, i.e. £1,100 (leaving £9,900), this being an *appropriation*. Where directors are entitled to a proportion of profits based upon DIVIDENDS, the usual practice is to show the amount payable to the directors thereunder as an appropriation.

Practice is fairly uniform in writing off discount on debentures and preliminary expenses to the Profit and Loss Appropriation Account.

Such expenses are of a capital nature, incurred not so much in the course of earning profits as prior to and necessary for the earning of future profits.

The phrase "profits available for dividends" is one often met with in practice, and its precise significance affects not only members but creditors, e.g. debenture holders where they are entitled to a proportion of "profits available for dividends." Such profits are not "available" *merely* because a profit during the period has been earned (*re Long Acre Press*), because the directors

are entitled (1) to make suitable reserves; and (2) to write off past losses (though not always BOUND so to do).

The result may be to leave no profits "available."

(18) A revaluation involving an increase of net assets may, subject to the Articles, be used to extinguish or reduce a debit balance of Profit and Loss (and so allow subsequent profits to be distributed). This procedure is one which is considered undesirable.

Capital Reserve. It is important to observe the circumstances which require the creation of a Capital Reserve. They are—

(1) [Usually] profit prior to incorporation. (See page 892 *et seq.*)

(2) The credit balance of Capital Reduction Account in a scheme of reduction of capital.

(3) Capital profits—

(*a*) Where there is a profit on realization of an *original* asset.

(*b*) Where there is a profit on realization of a fixed asset, but no surplus remains on the revaluation of the other assets.

(*c*) Where there is an *unrealized* accretion in the value of a fixed asset.

(4) Capital profits, as mentioned hereunder, where the Articles *forbid* distribution by way of cash dividends—

(*a*) Premiums on Debentures.

(*b*) Profit on Forfeited Shares or Surrendered Shares.

(*c*) Profit on Redemption of Debentures.

(5) Under Sect. 58, Companies Act, 1948, the heading of the account being Capital Redemption Reserve Fund. (See page 871.)

(6) Share Premium Account.

(7) The excess of net assets over purchase price on the acquisition of a business.

As regards (4), notwithstanding any provisions in the Articles, the profits therein enumerated cannot be distributed if the company has adopted the **Double Account System** (*Wall* v. *London and Provincial Trust*).

Profit and Loss Appropriation Account. The Appropriation Account is the final section of the Profit and Loss Account to which is carried the balance from the main Profit and Loss Account, representing the profit or loss for the current year.

By its utilization, particularly necessary in the case of limited companies, items representing appropriations of, rather than charges against, profits are eliminated from the main Profit and Loss Account, enabling it to exhibit the true result of the year's operations.

The Appropriation Account will thus include the balance of Profit and Loss Account brought forward, the result of the current year's operations brought down, and all items representing appropriations of profit: transfer to reserve, dividends, amounts written off goodwill, etc. Similarly, withdrawals from reserves and provisions no longer required should be credited to the Appropriation Account.

Illustration. Two typical Appropriation Accounts are appended. Students should carefully compare them, as in practice there is very little uniformity of layout.

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

(Previous Year) £		£	£	(Previous Year) £		£
—	To Reserve for increased replacement costs		15,000	140,000	By Balance brought forward from last year	120,000
50,000	,, General Reserve		25,000	260,000	,, Balance brought down from Profit and Loss Account	300,000
	,, Dividends (*less* Tax) for the year:			—	,, Transfer from Dividend Reserve	20,000
	Paid:			—	,, Provisions no longer required	10,000
50,000	6% Preference Shares, half-year to 30th June	50,000				
—	Ordinary Stock, interim dividend 5%	40,000				
		90,000				
	Proposed:					
50,000	6% Preference Shares, half-year to 31st Dec.	50,000				
130,000	Ordinary Stock, final dividend 25%	200,000				
			340,000			
120,000	,, Balance carried to Balance Sheet		70,000			
£400,000			£450,000	£400,000		£450,000

PROFIT AND LOSS APPROPRIATION ACCOUNT

	£	£	(Previous Year) £
Balance brought forward from last year		90,000	100,000
Net Profit for the year brought down		210,000	150,000
		300,000	£250,000
Less: Dividends (*less* Income Tax):			
Interim 10% (paid 30th June)	50,000		—
Final 20% (proposed)	100,000		100,000
	150,000		100,000
Appropriations recommended by the Directors:			
General Reserve	100,000		50,000
Staff Pension Fund	20,000		10,000
		270,000	£160,000
Balance carried to Balance Sheet		£30,000	£90,000

It should be noted that, although legally an appropriation of profits, Income Tax is often charged in the Profit and Loss Account and not in the Appropriation Account.

Agreements for additional remuneration by way of Share of Profits. A frequent form of remunerating responsible officials of a company is to give, in addition to a fixed salary, a share of profit. In

order to define the position clearly, a written agreement should be drawn up between the parties providing for—

(*a*) Commencement and period of the agreement with special regard to the conditions of service, termination of service before the expiry of the fixed period, and the position arising from illness or death of the official.

(*b*) How and when the extra remuneration shall be paid.

(*c*) The precise basis of computing the extra remuneration, that is, the exact meaning of the word "profit."

The following points call for precise determination—

(i) Is the profit to be net trading profit or net profit (i.e. including all other forms of profit, e.g. dividends receivable) or net profit available for dividend, in which case the Directors could quite properly under Table A, or where articles provided, make suitable allocations to reserve or against contingencies, or write off Discount on Debentures, Goodwill, etc., and choose not to regard the surplus as available for dividend until a past loss had been overtaken (*re Long Acre Press*); on the other hand the company might be under a contractual obligation to set aside a certain amount of profit each year toward building up a Sinking Fund for Debenture Redemption.

The profit might include transfers from Reserves, exceptional and non-recurring gains, etc.

Furthermore, even where NET PROFIT is taken as the basis it would seem that *all* profit should be brought in, not only Revenue but Capital Profit (*re Spanish Prospecting Co.*).

(ii) In respect of depreciation, the question arises as to what asset is to be written down and how. Where, however, no specific reference is made it would seem that depreciation of fixed (probably excluding Goodwill) and wasting assets should be provided for on the fixed instalment method in preference to diminishing balance method which would throw a heavier burden in the early years of the life of the asset. (*Edwards* v. *Saunton Hotels*.)

(iii) Unless clearly agreed otherwise, Profits Tax[1] is chargeable against net Profit[2] (*in re Ollivants' Agreement, Edwards* v. *Saunton Hotels*) but Income Tax (still regarded in law as an appropriation of profit) is not so chargeable. Consideration would have to be given to the question of the correctness of the tax provided for.

(iv) In the absence of clear agreement to the contrary, the extra remuneration is *not* to be charged against net profit for the purpose of arriving at such extra remuneration (*Edwards* v. *Saunton Hotels*); if therefore the extra remuneration is one-tenth of net profit, it is exactly that, not one-eleventh as if the extra remuneration had to be charged in arriving at the net profit upon which the extra remuneration is based.

[1] It may well be that such tax levied on the distributed portion of profits will be regarded as an appropriation.

[2] The same principle applies in computing profit for the purposes of sale of a business.

Managers' and Directors' Commissions. This type of problem is frequent in the examinations, and the following illustration should be worked through carefully.

Illustration. You are appointed auditor of the A1 Trading Co., Ltd., and the following account is submitted to you—

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 19..

Dr. | *Cr.*

		£			£
To Office and Administration Expenses		14,983	By Balance from Trading Account	b/d	66,973
,, Travelling and Distribution Expenses		20,395	,, Interest on Investments (Gross)		4,983
,, Special Newspaper Advertising		900	,, Transfer Fees		274
,, Income Tax		4,612			
,, Interest on Debentures (Gross)		4,200			
,, Directors' Fees		4,000			
,, Preliminary Expenses		1,600			
,, Depreciation of Plant		2,500			
,, Transfer to Pension Fund		2,700			
		55,890			
,, Balance	c/d	16,340			
	£	72,230		£	72,230
			By Balance	b/d	16,340

The Pension Fund is the property of the company, and the amounts allocated thereto are at the discretion of the directors, and are subject to the approval of the shareholders.

The managing director's agreement entitles him to a commission of 5 per cent on the profits; and the Articles of Association provide for a commission, payable to the directors, of 1½ per cent on the maximum amount which could be distributed by way of dividend out of the net profits of the year.

You are required to show the amounts due to the directors and the managing director respectively, showing in detail how the figures are arrived at, and explaining the reason for any adjustment you make. (Take income tax at 9s. in the £.)

Ignore Profits Tax and calculate to nearest £.

Solution. The term "profits" should, and probably will, be defined in the agreement with the managing director. Where the rights of a third party intervene, the term, failing such definition, means *actual* profits, i.e. the increase in net assets between two given dates, making allowance for any capital introduced or withdrawn during that interval. It is observed that the word "profits" is used in this instance, not "trading profits," hence all the credits to profit and loss should remain.

Income tax is an appropriation of profits (*Johnston* v. *Chestergate Hat Manufacturing Co.*); preliminary expenses are an appropriation of profits to a capital charge; the pension fund appears also to be an appropriation of profits: these items must, therefore, be added back in arriving at the profits on which the managing director's commission is to be based.

Since the Articles themselves give the directors their commission, it would appear that this is additional remuneration, and so must be charged before arriving at "profits," for the purpose of the managing director's commission.

Net profits available for dividend would appear to mean the amount available after charging the managing director's commission, and appropriating such profits as are necessary for meeting preliminary expenses and pension fund. The balance shown in the accounts is the maximum amount available for *net* dividends; this should be grossed up for the purpose of computing the directors' commission.

The Profit and Loss Account must be adjusted as follows—

COMPUTATION OF PROFITS

	£
Balance per Accounts	16,340
Add Income Tax	4,612
,, Preliminary Expenses	1,600
,, Transfer to Pension Fund	2,700
	25,252
Deduct Directors' Commission (below)	412
Profits	£24,840
Managing Director's Commission, 5%	£1,242

COMPUTATION OF "PROFITS AVAILABLE FOR DIVIDEND"

	£
Balance per Accounts	16,340
Deduct Managing Directors' Commission (as above)	1,242
	15,098
Add Income Tax to bring up to a gross equivalent, i.e. $\frac{9}{11}$ of £15,098	12,353
	£27,451
Directors' Commission, 1½% thereon	£412

It is assumed that the managing director's commission is not to be computed on the profits *after* charging his commission, and therefore the calculation is based upon the profits *before* such charge is made.

Calculation—

Let x = Managing Director's Commission

y = Directors' Commission

Then
$$x = \frac{5}{100} \times \left\{25{,}252 - \left(\frac{1\frac{1}{2}}{100} \times \frac{20}{11}\left(16{,}340 - x\right)\right)\right\}$$
$$= \frac{1}{20} \times \left\{25{,}252 - \left(\frac{49{,}020 - 3x}{110}\right)\right\}$$
$$\therefore \quad 20x = 25{,}252 - \left(\frac{49{,}020 - 3x}{110}\right)$$
Hence, $x = \underline{\underline{£1{,}242}}$

By substitution, y can now be computed—

$$y = \frac{1\frac{1}{2}}{100} \times \frac{20}{11}(16{,}340 - x)$$

$$= \frac{3}{110}(16{,}340 - 1{,}242)$$

$$= \frac{3}{110}(15{,}098)$$

Hence, $y = \underline{\underline{£412}}$

Notes. (1) If the managing director's commission is to be computed on the profits *after* charging both commissions, the calculation will be as shown in (i) below.

(2) If the directors' commission is also to be computed on the profits *after* charging both commissions, the calculation will be as shown in (ii) below.

(i) Let x = Managing Director's Commission in £'s
y = Directors' Commission in £'s

(*a*) $$x = \frac{5}{100}(25{,}252 - x - y)$$

$$20x = 25{,}252 - x - y$$
$$21x = 25{,}252 - y$$
$$\therefore \quad y = \mathit{25{,}252 - 21x}$$

(*b*) $$y = \frac{1\frac{1}{2}}{100} \times \frac{20}{11}(16{,}340 - x - y)$$

$$= \frac{3}{110}(16{,}340 - x - y)$$

$$110y = 49{,}020 - 3x - 3y$$
$$113y = 49{,}020 - 3x$$

Substitute for y the foregoing figures in italics.

$$49{,}020 - 3x = 113(25{,}252 - 21x)$$
$$= 2{,}853{,}476 - 2{,}373x$$
$$2{,}370x = 2{,}804{,}456$$
$$x = \underline{\underline{£1{,}183\ 6s.\ 4d.}}$$

Substituting £1,183 6s. 4d. for x in (*b*)—

(ii) $$y = \frac{1\frac{1}{2}}{100} \times \frac{20}{11}(16{,}340 - x - y)$$

$$= \frac{3}{110}(16{,}340 - 1183{\cdot}3 - y)$$

$$y = \underline{\underline{£402\ 8s.}}$$

[*Alternative to (ii), substituting £1,183 6s. 4d. for x in the foregoing figures in italics in (i) (a)*—

$$y = 25{,}252 - 21x$$
$$= 25{,}252 - 21\ (1{,}183{\cdot}3129)$$
$$= 25{,}252 - 24849{\cdot}57$$
$$= 402{\cdot}43$$
$$y = \underline{\underline{£402\ 8s.\ 7d.}}$$

The 7d. difference arises by reason of the fact that £1,183 6s. 4d. is to the nearest 1d.]

The statements of commission are—

	£	s.	d.	£	s.	d.
Managing Director's Commission—						
Profits (as adjusted)				25,252	0	0
Less Managing Director's Commission (x)	1,183	6	4			
Directors' Commission (y) .	402	8	0			
				1,585	14	4
				£23,666	5	8

5% thereon £1,183 6s. 4d.

	£	s.	d.	£	s.	d.
Directors' Commission—						
Profits				16,340	0	0
Less Managing Director's Commission (x)	1,183	6	4			
Directors' Commission . .	402	8	0			
				1,585	14	4
				14,754	5	8
Add Income Tax $\frac{9}{11}$ of £14,754 5s. 8d. (equals 9s. in the £ on £26,825 19s. 3d.)				12,071	13	7
				£20,825	19	3

1½% thereon = £402 8s.

Illustration. Components Ltd. employ a manager who is entitled to a commission of 10 per cent, in addition to a salary of £500 per annum, on "the sum available for distribution arising in each year."

The Profit and Loss Account for the Company's first year of trading (the year ended 31st March, 1954) is as follows—

		£		£
To General Expenses . . .		4,500	By Gross Profit . . .	40,000
,, Staff Bonus		1,500	,, Investment Income (net) . . .	2,430
,, Income Tax		16,000	,, Deposit Interest (gross)	100
,, Depreciation		1,000		
,, Manager's Salary .	£500			
,, Manager's Commission	500			
		1,000		
,, Net Profit		18,530		
		£42,530		£42,530

Compute the Commission due to the Manager (who has no shares in the company) assuming that the agreement as to commission makes no further reference to the basis and manner of computation, except that his commission, but *not* his salary, is to be charged for the purpose of arriving at his commission.

Wear and Tear allowance is £600. Ignore Profits Tax.

In the absence of further details in the agreement—

(1) Depreciation should be computed on the "straight line" method, sufficient to extinguish the assets or reduce them to estimated realizable value at the end of their effective life. (*Edwards* v. *Saunton Hotels.*) It is assumed that depreciation is on this basis.

(2) Income Tax is an appropriation of and not a charge against profits and will be added back to the net profit. (*Johnston* v. *Chestergate Hat Manufacturing Co.*)

(3) The manager will be entitled to one-eleventh of the profit as adjusted.

(4) Being the first year the Income Tax will be based upon the results of the current year.

(5) Included in the item for manager's salary and commission is £500 which it is assumed is a payment or credit on account of the commission due for the year ended 31st March, 1954.

(6) The articles of association are assumed not to contain any restrictive definition of sums available for distribution.

(7) The question of the treatment of previous years' losses does not arise as the business is in its first year.

Computation—

	£
Net Profit	18,530
Manager's Salary and Commission	1,000
Income Tax per accounts	16,000
Income Tax deducted at 9s. in £ on £4,418 (i.e. net £2,430)	1,988
	£37,518

$\frac{1}{11} \times$ £37,518 = £3,411 (which is 10% of £34,107).

The sum now due, therefore, is £3,411 — £500 paid or credited on account = £2,911.

Illustration. Assuming the same facts, except that the commission is based on profit *before* charging such commission as well as salary, the commission will be 10 per cent of £37,518 = £3,752.

This is the correct basis as far as commission is concerned in the absence of an agreement to the contrary.

Illustration. Same facts as stated on page 941, except that in addition to commission being charged (but not salary) Income Tax Sch. D at 9s. in the £ is to be charged for the purpose of arriving at the profit on which the manager's commission is payable. It may be assumed that the general expenses are all admissible for tax purposes:

Let C = Commission; and T = Income Tax.

$C = \frac{1}{11}(35{,}530 - T)$ (see page 943.)

$T = \frac{9}{20}(33{,}600 - 600 - C)$ (see page 943.)

The computations for Commission and Income Tax are—

	Commission	*Income Tax*
	£	£
Net Profit	18,530	18,530
Manager's Commission paid (or credited)	500	500
Manager's Salary	500	—
Depreciation	—	1,000
Income Tax	16,000	16,000
	35,530	36,030
Less Taxed Dividends . . .		2,430
		33,600
Wear and Tear . . .		600
		33,000
Income Tax . . .	T	
Commission . . .		C
	35,530 — T	33,000 — C

[The deposit Interest would fall to be assessed separately under Case III Sch. D and would be deducted from the business profit, but the total tax liability would be the same.]

$$C = \tfrac{1}{11}(35{,}530 - T)$$

$$C = \tfrac{1}{11}[35{,}530 - \tfrac{9}{20}(33{,}000 - C)]$$

$$11C = \left[35{,}530 - \left(\frac{297{,}000 - 9C}{20}\right)\right] \text{ or } 11C = 35{,}530 - \frac{297{,}000 - 9C}{20}$$

$$220C = 710{,}600 - 297{,}000 + 9C \qquad = 35{,}530 - 14{,}850 + \tfrac{9}{20}C$$

$$220C = 413{,}600 + 9C \qquad = 20{,}680 + \tfrac{9}{20}C$$

$$211C = 413{,}600 \qquad 220C = 413{,}600 + 9C$$

$$211C = 413{,}600$$

$$\therefore\ C = \underline{\underline{£1{,}960}} \qquad \therefore\ C = \underline{\underline{£1{,}960}}$$

Income Tax payable is—	£
Profit, as adjusted . . .	33,600
Less Manager's Commission .	1,960
	31,640
Less Wear and Tear . .	600
	£31,040

Income Tax at 9s. in £ thereon = £13,968

Manager is, therefore, entitled to $\tfrac{1}{11}$ £(35,530 − 13,968)
$= \tfrac{1}{11} \times$ £21,562
= £1,960 = 10% of £19,602*

Manager receives £1,960 − £500 paid to him on account = £1,460

*The item of £19,602 is arrived at thus—	£
Profit	35,530
Less Income Tax . .	13,968
	21,562
Less Commission . .	1,960
	£19,602

If Income Tax were calculated—as the ascertainment of either Tax or Commission gives the figure for the other, there is no need to compute BOTH —the calculation is—

Let $T = \text{Income Tax}$

then, $T = \frac{9}{20}(33{,}000 - C) \qquad C = \frac{1}{11}(35{,}530 - T)$

$$\begin{aligned}
20T &= 297{,}000 - \tfrac{9}{11}(35{,}530 - T) \\
&= 297{,}000 - 29{,}070 + \tfrac{9}{11}T \\
&= 267{,}930 + \tfrac{9}{11}T \\
220T &= 2{,}947{,}230 + 9T \\
211T &= 2{,}947{,}230 \\
\therefore\ T &= \underline{\underline{£13{,}968}}
\end{aligned}$$

Payment of Interest on Construction Capital. In the ordinary course of affairs no dividends may be paid unless such dividends are paid out of profits: interest on debentures (being a charge) is, however, payable whether profits are earned or not. Where a company raises share capital and out of the proceeds defrays the expenses of the construction of any works or buildings or provision of plant which cannot be made profitable for a lengthened period, the company may pay interest on so much of that share capital as is paid up for the period, and may charge to capital the sum so paid by way of interest, provided that the restrictions imposed by Sect. 65 of the Companies Act, 1948, are complied with, viz.—

Authority for the payment must be given by the Articles *or* by special resolution, *and* must, in addition, have been previously sanctioned by the Board of Trade, who shall determine the period, which in *no* case shall continue beyond the close of the half-year next after the half-year during which the works or buildings have been actually completed or plant provided.

The rate of interest shall in no case exceed 4 per cent per annum or such *other* rate as may for the time being be fixed by order of the Treasury (such order being laid before both Houses of Parliament)[1] and the payment shall not operate as a reduction of the amount paid up on the shares in respect of which it is paid.

The *accounts* of the company shall show the share capital *on* which and the rate *at* which interest has been paid out of capital during the period to which the accounts relate.

The above section is not confined to *new* companies, and in every case before sanctioning any such payment the Board of Trade may appoint a person to inquire into the circumstances and charge the expense of the inquiry to the company, which may be required to give security for the payment of the cost of the inquiry.

Illustration. The formalities completed and the Board of Trade sanction granted, a company pays on 6,000 shares of £1 each fully paid interest at 5 per cent per annum for one year. Show Journal entries, taking Income Tax at 9s. in £.

[1] This at present is fixed at 6 per cent per annum.

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	£	£
Interest on Construction Capital . *Dr.*	300	
To Members (Interest on Construction Capital)		300
Being interest on 6,000 shares of £1 each fully paid at 5% per annum, per articles, Board of Trade sanction, and directors' resolution dated........*vide* Minute Book, p.....		
Asset(s)[1] . . . . *Dr.*	300	
To Interest on Construction Capital .		300
Being transfer to asset(s) of interest on construction capital.		
Members (Interest on Construction Capital) . . . . . . *Dr.*	300	
To Cash		165
,, Income Tax		135
Being payment of interest due *less* tax.		

The interest so paid is "capitalized," that is to say, it is treated as part of the cost of construction, being added thereto (similarly to the legal expenses of acquiring property or brokers' charges on purchasing investments).

So far as income tax is concerned, the payment is not a capital payment, and income tax must be deducted in the ordinary way.

The same rule applies, *mutatis mutandis*, to interest on "Construction Debentures," so that the company may adopt the same procedure if it decides to finance the construction by way of debentures in preference to shares. (*Hinds* v. *Buenos Ayres Tramways Co.*)

Table A. References have been made throughout to Table A, and as the matters contained therein are of extreme importance, the vital clauses, in so far as they relate to accounts, are summarized below (the clauses being those in the 1948 Act)—

Clause 15. The Directors may from time to time make calls subject to there being not more than one call made in any calendar month: no call must exceed 25 per cent of the nominal value of the share: at least 14 days' notice of the call must be given.

Clause 18. If a call is not paid by the day appointed the person from whom it is due shall be liable to pay interest at 5per cent per annum, but the Directors may waive payment of such interest wholly or in part.

Clause 20. The Directors may, on the issue of shares, differentiate between the holders as to the amount of calls to be paid and the times of payment.

Clause 21. If a call is paid in advance the Directors may pay interest thereon, but the rate shall not exceed 5 per cent (6 per cent under the 1929 Act) without the consent of the Company in General Meeting.

Clause 33.
Clause 34.
Clause 35. } The Directors have power to forfeit shares for non-payment of calls by resolution after giving 14 days' notice of such intention.

[1] Apportioned where necessary amongst the various fixed assets, based as far as possible on the actual capital employed in the construction of each particular fixed asset.

Clause 40. The Company may by Ordinary Resolution convert paid-up Shares into Stock, and reconvert Stock into paid-up Shares of any denomination.

Clause 44. The Company may by Ordinary Resolution increase the Share Capital.

Clause 45. The Company may by Ordinary Resolution—

(*a*) Consolidate and divide all or any of its Share Capital into Shares of larger amount.

(*b*) Subdivide all or any of its existing Shares into Shares of smaller amount, subject to the provisions of Sect. 61 (1) (*d*), Companies Act, 1948.

(*c*) Cancel any Shares which, at the date of the resolution have not been taken or agreed to be taken by any person.

Clause 46. The Company may by Special Resolution reduce its Share Capital, any Capital Redemption Reserve Fund, or any Share Premium Account in any manner and with, and subject to, any incident authorized and consent required by law.

Clause 58. At any General Meeting a vote shall be decided by a show of hands: a poll may be demanded by the chairman or at least three members present in person or by proxy, or even by one, or two, if they represent not less than one-tenth of the total voting rights of all the members having a right to vote at the meeting or hold shares in the company conferring a right to vote at the meeting, being shares on which an aggregate sum has been paid up equal to not less than one-tenth of the total sum paid up on all the shares conferring this right.

Clause 62. On a show of hands every member present in person shall have one vote. On a poll every member shall have one vote for each Share of which he is the holder.

Clause 76. The remuneration of the Directors, which shall be deemed to accrue from day to day, shall be determined by the Company in General Meeting [if none voted, no remuneration]. [By Clause 108 the Managing Director's remuneration shall be fixed by the Directors.]

Clause 77. No share qualification is required unless fixed by the Company in General Meeting.

Clause 79. The amounts borrowed, for the Company's business, by the Directors (other than capital and temporary overdrafts) shall at no time exceed the nominal amount of the issued Share Capital of the Company without the sanction of the Company in General Meeting.

Clause 114. The Company in General Meeting may declare dividends, but no dividend shall exceed the amount recommended by the Directors.

Clause 115. The Directors may from time to time pay to the members such interim dividends as appear to the Directors to be justified by the profits of the Company.

Clause 116. No dividend shall be paid otherwise than out of profits.

Clause 117. The Directors may set aside out of profits any reserves they think proper.

Clause 118.[1] Subject to the rights of persons, if any, entitled to shares with special rights, all dividends shall be payable on the amounts PAID UP [according to the dates paid unless the terms of issue provide for shares to rank for dividend from a particular date] on the shares (Calls in Advance *whilst bearing interest* do not rank for dividend).

General Illustration. The following facts are ascertained from the books of Prosperity, Ltd.—

The ordinary shares had been issued at a premium of 4s. on 31st May, 19..; 20,000 preference shares had been redeemed at par out of profits on 30th June, 19.. and the half-year's dividend on the preference shares had been paid to that date, and an

[1] If this clause has been eliminated by the Articles and no other provision has been made, dividends will be payable on the NOMINAL value.

interim of 2 per cent actual on the ordinary shares had been declared and paid on 25th December, 19... On 20th December, 1,200 shares were forfeited for failure to pay calls (due on 30th June) of 10s. a share, and 200 were reissued as fully paid for 15s. a share on the same day as the forfeiture.

A member holding 800 ordinary shares with calls in arrear of 10s. a share had been charged and had paid interest for the half-year to 31st December, 19.., in accordance with the rate chargeable under Table A (which the company had adopted).

The investments of which £40,000 were quoted on a recognized Stock Exchange were revalued at the previous 31st December and taken in the Balance Sheet at £45,000.

The debentures had been issued on 1st January, 19.., at a discount of 10 per cent, and on 30th June, 19.., £20,000 were redeemed at par out of current profits and cancelled. Interest on debentures had been paid to 30th June, 19... All the shares were £1 shares. The preference shares are fully paid and the Directors propose to pay the half year's dividend thereon to 31st December.

In addition to the accounts arising out of the above, the following balances are extracted from the books of the company on 31st December, 19..—

	£		£
6% Debentures, *Net*	34,000	Profit and Loss (*Cr.*)	29,000
Plant and Machinery	38,000	Gross Profit (from Trading Account)	60,000
Stock at 31st December, 19..	28,675	General Expenses	62,000
Debtors	115,000	Debenture Interest	1,800
Investments at Cost	50,000	Ordinary Share Capital fully paid	50,000
Creditors	49,000	7% Redeemable Preference Share Capital fully paid	50,000
Dividends Received	2,600		
Bank (*Dr.*)	9,863		

No entries have been made in reference to the shares forfeited and reissued.

The investments at 31st December, 19.., were revalued at £49,200, and are to be taken in the Balance Sheet at that figure.

No Debenture Redemption Fund has been created.

The Profit and Loss balance is the balance of the preceding year's profit, after the adjustment required for the redemption of the preference shares, and the balance standing to the credit of Preference Share Capital Account is that after the redemption mentioned in the question has been carried out.

£3,000 had been debited to the Trading Account in respect of depreciation for the year. The Plant and Machinery Account balance of £38,000 is the written down value. Depreciation provided prior to the current year amounts to £5,000.

Prepare Profit and Loss Account and Balance Sheet in respect of the year to 31st December, 19... Ignore Tax.

[It is advisable to draw up a Trial Balance.]

The Trial Balance at 31st December, 19.., is—

Trial Balance	Dr.	Cr.
	£	£
Ledger Accounts as shown		
6% Debentures		34,000
Plant and Machinery	38,000	
Stock-in-trade	28,675	
Debtors	115,000	
Investments (*see h below*)	50,000	
Bank	9,863	
Creditors		49,000
Dividends Received		2,600
Debenture Interest	1,800	
Profit and Loss Account		29,000
Gross Profit		60,000
General Expenses	62,000	
Ordinary Share Capital (*see j below*)		50,000
7% Redeemable Preference Share Capital		50,000
	305,338	274,600
Balances not shown in Ledger Accounts presented		
(*a*) Dividends: Preference	2,450	
(*b*) ,, Ordinary	972	
(*c*) Capital Redemption Reserve Fund		20,000
(*d*) Premium on Shares Forfeited		50
(*e*) Share Premium		10,000
(*f*) Calls in Arrear	400	
(*g*) Interest on Calls in Arrear		10
(*h*) Investment Provision		5,000
(*i*) Forfeited Shares		500
(*j*) Ordinary Share Capital, Shares Forfeited	1,000	
	£310,160	£310,160

Adjustments must be made in respect of (*a*) investment provision; (*b*) debenture interest accrued; (*c*) debenture discount, for the preparation of the Profit and Loss Account, as follows:

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	£	£
(*a*) Investment Provision . . . *Dr.*	4,200	
To Profit and Loss Appropriation Account		4,200
[To bring provision back to £800.]		
(*b*) Debenture Interest . . . *Dr.*	1,200	
To Sundry Debenture Holders		1,200
[Interest at 6% per annum on £40,000 debentures, for half-year ended 31st December, 19...]		
(*c*) Debenture Discount . . . *Dr.*	6,000	
To 6% Debentures		6,000
[Adjustment of omission of entry to Debenture Discount Account.]		

The bank balance (£9,863) is not affected by any of the adjustments, being the correct figure, all bank entries having been made.

The debentures originally issued were £60,000 and the discount thereon £6,000; as £20,000 have been redeemed the debentures outstanding are £40,000, so that a transfer is required as in (c) above. The non-record of the debenture discount does not disturb the *agreement* of the Trial Balance.

The items not shown in the Ledger Accounts presented are arrived at as follows—

(a) *Dividend on Preference Shares.*

7% for half year on £70,000 = £2,450

(b) *Dividend on Ordinary Shares.* This is computed on paid-up capital—as the company has adopted Table A—of 49,000 shares, i.e. 50,000 less 1,000.

	£
2% on 48,200 Ordinary Shares of £1 each fully paid =	964
2% on 800 Ordinary Shares of £1 each 10s. paid =	8
	£972

[If the 1,200 shares had been forfeited *after* the payment of the dividend, the latter would have been £980, arrived at as follows—

	£
2% on 48,000 Ordinary Shares of £1 each *fully* paid =	960
2% on 2,000 Ordinary Shares of £1 each 10s. paid =	20
	£980

If the 200 shares out of the 1,200 forfeited *before* the payment of the dividend had not been reissued until *after* the payment of the dividend, the latter would have been £968, arrived at as follows—

	£
2% on 48,000 Ordinary Shares of £1 each *fully* paid =	960
2% on 800 Ordinary Shares of £1 each 10s. paid =	8
	£968]

(c) *Capital Redemption Reserve Fund.* This represents the profits applied in the redemption of redeemable preference shares.

(d) *Premium on Shares Forfeited.*
(e) *Share Premium Account.*
(f) *Calls in Arrear.*
(i) *Forfeited Shares.*
(j) *Ordinary Share Capital.*

(Accounts in explanation of (d), (e), (f), (i), and (j) are appended.)

Dr. ORDINARY SHARE CAPITAL *Cr.*

19..			£	19..			£
Dec. 20	To Forfeited Shares Account		1,200	June 30	By Balance	b/d	50,000
31	,, Balance	c/d	49,000	Dec. 20	,, Forfeited Shares re-issued		200
		£	50,200			£	50,200
				19.. Jan. 1	By Balance	b/d	49,000

Dr. SHARE PREMIUM Cr.

19 . . Dec. 31	To Balance . . .	c/d	£ 10,000	19 . . June 30	By Cash . . .		£ 10,000
		£	10,000			£	10,000
				19 . . Jan. 1	By Balance . . .	b/d	10,000

Dr. CALLS Cr.

19 . . June 30	To Ordinary Share Capital Account . . .		£ 25,000	19 . . June 30	By Cash . . . ,, Calls in Arrear Account		£ 24,000 1,000
		£	25,000			£	25,000

Dr. CALLS IN ARREAR Cr.

19 . . June 30	To Calls Account . .		£ 1,000	19 . . Dec. 20	By Forfeited Shares Account . . .		£ 600
				31	,, Balance . . .	c/d	400
			£1,000				£1,000
19 . . Jan. 1	To Balance .	b/d	400				

Dr. FORFEITED SHARES Cr.

19 . . Dec. 20	To Calls in Arrear Account		£ 600	19 . . Dec. 20	By Ordinary Share Capital Account. . .		£ 1,200
	,, Ordinary Share Capital Account. . .		200		,, Cash . . .		150
	,, Premium on Shares Forfeited Account .		50				
31	,, Balance . . .	c/d	500				
			£1,350				£1,350
				19 . . Jan. 1	By Balance . . .	b/d	700

Dr. PREMIUM ON SHARES FORFEITED Cr.

				19 . . Dec. 20	By Forfeited Shares Account . . .		£ 50

(*g*) *Interest on Calls in Arrear.*

5% for half year on £400 = £10

(*h*) *Investment Provision.* It is clear that there must be a provision of £5,000 in the books offsetting the item of £50,000 investments AT COST. An adjustment of £4,200 is required. (See Journal entry (*a*), page 948.)

Profit and Loss Account for the Year ended 31st December, 19..

Dr.		£			*C* £
To General Expenses		62,000	By Gross Profit	b/d	63,000*
,, Balance	c/d	1,000			
		£63,000			£63,000
To Depreciation		3,000	By Balance †	b/d	1,000
,, Directors' Emoluments		?	,, Dividends Received		2,600
,, Debenture Interest [1]		3,000	,, Interest on Calls in Arrear		10
			,, Balance	c/d	2,390
		£6,000			£6,000
To Balance, being Loss for the year	b/d	2,390	By Investment Provision no longer required		4,200
,, Capital Redemption Reserve Fund[2]		20,000	,, Balance from previous year[2]		49,000
,, Dividends:					
Paid:					
Preference, half-year to 30th June		2,450			
Ordinary Interim 2% actual		972			
Proposed:					
Preference, half-year to 31st December		1,750			
,, Balance carried to Balance Sheet		25,636			
		£53,200			£53,200

* Per question £60,000 plus Depreciation £3,000.
† The published account would start with this balance.

See page 952 for Balance Sheet.

Examination Problem

The authorized capital of Sellers, Ltd., is £500,000, consisting of 250,000 cumulative preference shares of £1 each and 250,000 ordinary shares of £1 each. The balances appearing in the books on 31st December, 1953, were as shown below and on page 953.

Debits	£
Investments in Subsidiary Company at Cost—Shares £20,000, Debentures £20,000	40,000
Purchases	501,150
Packing Wages	25,000
Stock at 1st January, 1953	160,500
Delivery Expenses	43,330
Charges Paid against Consignments Unsold	1,750

[1] The item of £3,000 Debenture Interest is computed as follows—

	£
Debenture Interest on £60,000 @ 6% per annum for half-year to 30th June, 19..	1,800
Debenture Interest on £40,000 @ 6% per annum for half-year to 31st December, 19..	1,200
	£3,000

[2] The balance forward *before* transfer to Capital Redemption Reserve Fund of £20,000 must have been £49,000. The items in italics account for item of £29,000 in the Trial Balance.

PROSPERITY LIMITED

Balance Sheet as at 31st December, 19..

	£	£
***Capital and Surplus*—**		
Share Capital:		
Authorized	?	
Issued:		
50,000 7% Redeemable Preference Shares of £1 each, fully paid (? earliest date of redemption)		50,000
49,000 Ordinary Shares of £1 each	49,000	
Less Calls in Arrear	400	
		48,600
		98,600
Capital Reserves:		
Capital Redemption Reserve Fund	20,000	
Share Premium Account	10,000	
Forfeited Shares[1]	500	
Premium on Forfeited Shares[2]	50	
		30,550
Profit and Loss Account		25,638
		154,788
6% *Debentures* (*? secured*)		40,000
Provision—		
Depreciation of Investments		800
Current Liabilities—		
Trade Creditors	49,000	
Debenture Interest	1,200	
Proposed Preference Dividend	1,750	
		51,950
		£247,538

		£	£
Fixed Assets—			
Plant and Machinery at cost		46,000	
Less Accumulated Depreciation		8,000	
			38,000
Current Assets—			
Stock-in-Trade		28,675	
Debtors		115,000	
Investments at Cost:			
Quoted (Market Value ?)	£40,000		
Unquoted	10,000		
		50,000	
Cash at Bank		9,863	
			203,538
Debenture Discount[3]			6,000
} *Directors.*			
			£247,538

[Auditors' Report]

[1] 1,000 shares at 10s. [i.e. application and allotment, excluding premium].
[2] The Premium on Shares Forfeited Account may be transferred to reserve or utilized to write off debenture discount.
[3] It would be advisable to write off a proportion of the debenture discount as one-third of the debentures have been redeemed.

Debits—(*continued*)	£
Salaries, Travelling Expenses, and Commission	69,750
Rent, Rates, and General Expenses	34,500
Bad Debts written off	250
Freight and Carriage Inwards	2,500
Bills Paid against Consignments not finally dealt with	60,000
Final Dividends for 1952	13,500
Preference Dividend: Half-year to 30th June, 1953	3,300
Commission on Issue of Debentures: Balance as on 1st January, 1953	2,500
Balance at Bankers	65,000
Bills Receivable	3,750
Debenture Interest: Half-year to 30th June, 1953, *less* Tax	1,925
Trade Debtors	55,000
Freehold Property and Goodwill at Cost	390,000
Furniture, Fixtures, and Fittings at Cost *less* Depreciation (£10,000)	50,000

Credits	
Taxation	5,875
Sales	792,000
Sales *ex* Consignments not finally dealt with	52,000
Dividends and Interest received	4,000
Profit and Loss Account	35,000
General Reserve (Revenue)	55,150
Shares Issued—	
6% Preference (200,000)	200,000
Ordinary (200,000, 15s. called up)	150,000
5% First Mortgage Debentures, secured on Freehold Properties	140,000
Sundry Consignors: Balances on Account Sales	20,000
Subsidiary Company: Current Account	2,000
Trade Creditors	61,680
Commission on Sales *ex* Consignments	6,000

[*Note.* Take Income tax at 9s. in £.]

Prepare Trading and Profit and Loss Account for the year ended 31st December, 1953, and Balance Sheet as on that date, after taking into account the following—

(*a*) The value of the stock on 31st December, 1953, was £155,000 and, in addition, there were stocks unsold in store ex sundry consignments invoiced *pro forma* at £20,000.

(*b*) The directors are entitled to £4,000 per annum remuneration; directors' fees of £1,000 were paid by the subsidiary company and, in addition, the managing director was paid the sum of £500 due under his employment agreement with that company.

(*c*) Bills receivable for £1,500, maturing after 31st December, 1953, had been discounted with the bank.

(*d*) Rent of warehouse at £1,000 a year had been paid for the half-year to 30th June, 1953; and rates amounting to £1,600 for half-year to 31st March, 1954, had been paid on 30th November, 1953.

(*e*) A provision of 5 per cent of trade debtors is to be created for bad and doubtful debts.

(*f*) Depreciation of furniture, fixtures, and fittings is to be provided for at 10 per cent on the written down value.

(*g*) Tax is to be provided on the 1953 profits as follows—

Income Tax Sch. D £43,150, Profits Tax £12,000. Ignore Sch. A and Tax on dividends received. There is no liability to E.P.L.

(*h*) £1,250 is to be written off Commission on Issue of Debentures Account.

(*i*) The freehold property and goodwill were purchased some years ago for a round sum, and that part of the purchase price attributable to goodwill is not known.

TRADING AND PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 1953

Dr. *Cr.*

			£			£
To Stock, 1st January, 1953			160,500	By Sales		792,000
,, Purchases			501,150	,, Stock, 31st December, 1953		155,000
,, Freight and Carriage Inward			2,500			
,, Gross Profit		c/d	282,850			
			£947,000			£947,000
To Rent, Rates, and General Expenses[1]			34,200	By Gross Profit	b/d	282,850
,, Packing Wages			25,000	,, Commission on Sales *ex* Consignments		6,000
,, Delivery Expenses			43,330			
,, Salaries, Travelling Expenses, and Commission			69,750			
,, Bad Debts			3,000			
,, Balance		c/d	113,570			
			£288,850			£288,850
To Debenture Interest			7,000	By Balance[4]	b/d	113,570
,, Directors' Emoluments[2]			4,000	,, Dividends and Interest[5]		4,000
,, Depreciation			5,000			
,, Taxation on current profits:						
Income Tax	£40,000[3]					
Profits Tax	12,000					
			52,000			
,, Balance		c/d	49,570			
			£117,570			£117,570
To Commission on Issue of Debentures			1,250	By Balance, 1st January, 1953		35,000
,, Preference Dividends (net):				*Less* Final Dividends (net) for 1952		13,500
Paid	£3,300					
Proposed	3,300					21,500
	6,600			,, Net Profit for the year	b/d	49,570
,, Proposed Ordinary Dividend (net)	?					
			6,600			
,, Balance carried to Balance Sheet			63,220			
			£71,070			£71,070

[1] £34,500 per Trial Balance plus Rent accruing £500, less Rates in advance £800.

[2] A note will be required on the following lines:

In addition to the amount shown above, £1,500 was paid by a subsidiary company. Of the total (£5,500), £? was paid as Directors and £? as Executives.

[3] £43,150 Sch. D per question less transfer from Debenture Interest £3,150, being tax at 9s. in the £ on £7,000.

[4] The published account would start with this balance.

[5] These would have been "grossed up," had the question not stated that tax on dividends, etc., received was to be ignored.

SELLERS LIMITED

Balance Sheet as at 31st December, 1953

	£	£	£
Capital and Surplus—			
Share Capital:			
Authorized:			
250,000 6% Cumulative Preference Shares of £1 each			250,000
250,000 Ordinary Shares of £1 each			250,000
			£500,000
Issued:			
200,000 6% Cumulative Preference Shares of £1 each, fully paid		200,000	
200,000 Ordinary Shares of £1 each, 15s. paid		150,000	
			350,000
Revenue Reserves:			
General		55,150	
Income Tax, 1954–55		43,150	
Profit and Loss Account		63,220	
			161,520
			511,520
5% *First Mortgage Debentures*			140,000
Current Liabilities—			
Trade Creditors		61,680	
Sundry Consignors:	£		
Balances on Account Sales	20,000		
Resales made	52,000		
(see note 5)		72,000	
Directors' Fees		4,000	
Rent accrued		500	
Mortgage Interest (secured)		1,925	
Subsidiary Company on Current Account		2,000	
Taxation (see Note 4)		17,875	
Proposed Preference Dividend (net)		3,300	
			163,280
Note. There is a contingent liability in respect of Bills discounted of £1,500.			£814,800

	£	£
Fixed Assets—		
Freehold Property and Goodwill at cost		390,000
Furniture, Fixtures, and Fittings at cost	60,000	
Less Accumulated Depreciation	15,000	45,000
		435,000
Investment in and Amount owing by Subsidiary—		
Shares at cost	20,000	
Debentures at cost	20,000	
		40,000
Current Assets—		
Stock	155,000	
Trade Debtors, *less* Provision (£2,750)	52,250	
Charges Paid against Consignments unsold	1,750	
Bills met against Consignments (See note 5)	60,000	
Rates Paid in Advance	800	
Bills Receivable	3,750	
Balance at Bankers	65,000	
		338,550
Commission on Issue of Debentures—		
Balance 1st January, 1953	2,500	
Less written off during year	1,250	
		1,250
} *Directors.*		
		£814,800

Notes—

(1) Much of the detail shown under Current Assets and Liabilities would not be published.

(2) Corresponding 1952 figures are required in the published accounts.

(3) Since there is a subsidiary company, group accounts will be required (see next chapter).

(4) The tax currently owing is £5,875 per question plus Profits Tax £12,000. The income tax (Sch. D) on the 1953 profits is not due until 1st January, 1955, and therefore shown as a Reserve.

(5) Part of these items could probably be set off against each other.

Illustration. Included in the Trial Balance of a company at 31st December, 1953, were the following items—

	£
7% Preference Share Capital, £1 fully paid	60,000
Ordinary Share Capital, £1 called	30,000
Debenture Interest, half-year to 30th June, 1953 . . .	2,250
Preference Dividend, half-year to 30th June, 1953 . . .	2,100
Calls in arrear (Ordinary shares: 600 at 5s.)	150
Provision for Taxation (on previous year's profits) . . .	12,000
Taxation Account—credit	1,957½
5% Debentures	90,000
Net Profit	26,651
Profit and Loss Account—Balance at 1st January, 1953—credit	2,642

Included in the matters requiring consideration in the preparation of the final accounts were—

(*a*) Debenture Interest for the half-year to 31st December had not been paid.

(*b*) Preference Dividend for the half-year to 31st December is to be provided for.

(*c*) Ordinary Dividend of 10 per cent for the year on the paid-up ordinary share capital is to be recommended.

(*d*) Estimated taxation on the current year's profits is £13,400. The provision appearing in the Trial Balance is the exact amount required to meet the tax liability payable on the following day (1st January).

Assuming tax at 9s. in the £, prepare the Profit and Loss Appropriation Account for the year, making such adjustments as you consider necessary.

PROFIT AND LOSS APPROPRIATION ACCOUNT
FOR THE YEAR ENDED 31ST DECEMBER, 1953

Dr.	£		*Cr.* £
To Debenture Interest .	4,500	By Profit b/d . . .	26,651
,, Profit c/d . . .	22,151		
	£26,651		£26,651
To Taxation	11,375	By Balance b/f . .	2,642
,, Preference dividend paid for the half-year to 30th June, 1953, *less* tax . . .	1,155	,, Net Profit for the year b/d. . . .	22,151
,, Proposed Dividends— Preference Dividend for the half-year to date, *less* tax . .	1,155		
Ordinary Dividend for the year to date—10% *less* tax . .	1,641¾		
,, Balance c/f . .	9,466¼		
	£24,793		£24,793

Notes. (1) It will be remembered that the modern practice is to show debenture interest gross in the accounts and to show dividends net. In regard to the former, the half-year's interest paid appears in the Trial Balance at the gross figure, the requisite transfer of £1,012½ (tax at 9s. on £2,250) having apparently been made to Taxation Account. A similar transfer has been made in respect of the provision for the second half-year's interest, leaving a credit balance of £1,237½ due to the debenture-holders. The Preference Dividend paid also appears in the Trial Balance at the gross figure, it having apparently been treated in the same way as the debenture interest. In order to show the *net* figure, it is necessary to reverse the transfer to Taxation Account by debiting that account with £945 and crediting the dividend account.

(2) The credit balance on Taxation Account seems to consist of the two transfers mentioned in (1). The balance will be increased by the transfer in respect of the second half-year's debenture interest and decreased by the reversal of the entry in respect of the dividend paid. The account will be debited with £13,400—the amount of the new provision required—and the balance carried to the Profit and Loss Appropriation Account. The provision already appearing in the Trial Balance has been kept separate for the sake of clarity.

It will be seen that the provision for taxation in the Balance Sheet at 31st December, 1953, will appear in two parts—

(*a*) A current liability of £12,000 in respect of the present fiscal year, based on the preceding year's profits and payable the following day; and

(*b*) A reserve for future taxation in the next fiscal year estimated at £13,400.

(3) The ordinary dividend is 10 per cent on the paid-up capital, i.e. £30,000 called *less* £150 calls in arrear.

(4) The transfers are shown in the following rough working accounts—

Dr. DEBENTURE INTEREST *Cr.*

	£		£
To Cash	1,237½	By Profit and Loss Account	4,500
„ Taxation	1,012½		
„ Taxation	1,012½		
„ Provision c/d	1,237½		
	£4,500		£4,500

Dr. PREFERENCE DIVIDEND *Cr.*

	£		£
To Cash	1,155	By Taxation (reversal of entry)	945
„ Taxation	945	„ Profit and Loss Appropriation Account	2,310
„ Provision c/d	1,155		
	£3,255		£3,255

Dr. TAXATION[1] *Cr.*

	£		£
To Preference Dividend	945	By Debenture Interest	1,012½
„ Provision c/d	13,400	„ Preference Dividend	945
		„ Debenture Interest	1,012½
		„ Profit and Loss Appropriation Account	11,375
	£14,345		£14,345

[1] Excluding £12,000 provision in respect of previous year's profits.

Published Accounts. The annual accounts sent to the members and debenture-holders of a company will usually consist of—

(*a*) Balance Sheet;
(*b*) Profit and Loss Account (and Appropriation Account);
(*c*) Auditors' Report;
(*d*) Directors' Report.

Usually the notice convening the Annual General Meeting is sent with the accounts and in most cases a copy of the Chairman's Speech or Statement is attached.

No two sets of accounts are exactly alike, and the student should take every opportunity of studying the published accounts of public companies.

(*a*) **Balance Sheet.** This will follow the form shown in the illustrations on pages 952 and 955, although in the latter (Sellers Ltd.) there would be less detail under Current Assets and Current Liabilities (e.g. Trade Creditors, Sundry Consignors, Directors' Fees and Rent accrued would appear as one item "creditors and accrued charges"). The rule to follow is to set out the facts as neatly and concisely as possible, subject to showing separately such information as is required by the Act.

(*b*) **Profit and Loss Account.** Only a short account is required giving the information laid down in the Act. Thus, there will usually be no detailed Trading or Profit and Loss Account; the published account will commence with "Profit on Trading for the [year]" to which will be added Dividends, Interest and other non-trading receipts (e.g. Transfer Fees) and against which will be debited Depreciation, Debenture Interest, Directors' Emoluments, Taxation and any other information required by the Act (e.g. Auditors' Remuneration if not voted in general meeting) or of a non-trading or exceptional nature. In the illustrations on pages 951 and 954 the accounts have been balanced off to indicate the parts which would normally be published.

(*c*) **Auditors' Report.** The matters to be included in the Auditors' Report have already been indicated on page 774. Where there are no group accounts and no qualification is necessary, the following standard form may be used:

Report of the Auditors to the Members of AB, Ltd.

We have obtained all the information and explanations which to the best of our knowledge and belief were necessary for the purposes of our audit. In our opinion, proper books of account have been kept by the company so far as appears from our examination of those books (and proper returns adequate for the purposes of our audit have been received from branches not visited by us). We have examined the above balance sheet and annexed profit and loss account which are in agreement with the books of account (and returns). In our opinion and to the best of our information and according to the explanations given us the said accounts[1] give the information required by the Companies Act, 1948, in the manner so required

[1] Where material information is given elsewhere (e.g. in the Directors' Report) reference should be made thereto.

and the balance sheet gives a true and fair view of the state of the company's affairs as at . . . and the profit and loss account gives a true and fair view of the profit (loss) for the (year) ended on that date.

(*d*) **Directors' Report.** An example appears on page 772.

(*e*) **Notice convening the Annual General Meeting.** A typical notice might be as follows—

Notice is hereby given that the Nth Annual General Meeting of the Company will be held at .... .on . 19.., at a.m. to receive the Company's accounts for the year ended and the Reports of the Directors and Auditors thereon, to confirm and declare dividends, to fix the remuneration of the Auditors, and to transact other ordinary business of the Company.

A note is also required under Sect. 136, Companies Act, 1948 to the effect that

Any member of the Company entitled to attend and vote at the General Meeting may appoint a proxy (who need not also be a member) to attend and vote instead of him.

Reference should be made to the 8th Schedule to the Companies Act, 1948, the contents of which are given on pages 786 to 800 for general provisions as to the Balance Sheet and Profit and Loss Account. Most of these matters are either self-explanatory or have already been illustrated. The following, however, are matters which may cause difficulty to the student—

(1) **Assets.** These will normally be divided into Fixed, Current and Fictitious (the latter covering Preliminary Expenses, etc.). Certain assets may be either fixed or current depending on the facts of a particular case (e.g. Investments). Other assets may be regarded as neither truly fixed nor current, in which case they may be grouped separately (e.g. Interests in Subsidiary and Associated Companies are often shown separately between Fixed and Current Assets).

The normal way of showing fixed assets is at cost (or, if standing in the books at a valuation, at that valuation) less accumulated[1] depreciation. If these cost or valuation figures cannot be obtained without unreasonable expense or delay in respect of any item, the net (written down) amount at which it stands in the books at 1st July, 1948 (or the company's prior accounting date) may be substituted as if it were a valuation made at that date.

For each type of fixed asset, therefore, there may be shown, under an appropriate heading (e.g. Plant and Machinery), one aggregate figure of cost and valuation (including where applicable the net book amount "valuation") less aggregate depreciation to date.

Illustration.

	£	£
Plant and Machinery—partly at cost, partly at independent valuation in 1940, and partly at the net amount standing in the Company's books at 1st July, 1948	150,000	
Less accumulated Depreciation	70,000	
		80,000

[1] I.e. since date of acquisition or valuation.

In certain cases such a presentation may not give the "true and fair view" required by the Act and it may be considered preferable to give more detail as follows, but in this event it must be remembered that for assets under each heading there must be shown the aggregate of (*a*) cost and valuation and (*b*) depreciation—

	£	£	£
Plant and Machinery:			
At cost *less* depreciation	150,000	50,000	
At the net amount standing in the Company's books at 1st July, 1948, *less* sales and depreciation	70,000	10,000	
	£220,000	£60,000	£160,000

Where there are several headings under Fixed Assets with considerable detail in each, it is often preferable to show on the face of the Balance Sheet only the final figures for each heading and to give the necessary details in a schedule attached to it.

(2) **Taxation.** Profits Tax on the current profits and any amounts outstanding for Income Tax, Profits Tax or E.P.L. on previous accounts will appear under Current Liabilities. Income Tax on the current profits (in normal cases, when the assessment is on a "preceding year" basis) is not strictly a liability at the Balance Sheet date. It should not, therefore, be classified as a Provision or Liability, but as a Reserve, and be either included with the aggregate of other reserves or shown separately. Taking the latter view, some accountants show it as a separate heading between Reserves and Provisions as "Amount set aside for United Kingdom Income Tax 1953–54" (e.g. in a Balance Sheet at 31st December, 1952). The basis on which the amount set aside has been computed must always be indicated.[1]

(3) **Directors' Emoluments.** The information to be given is laid down in Sect. 196 of the Act (see page 795). In the normal simple case the item may be shown as follows—

Directors' Emoluments:		or	Directors' Emoluments:	
Fees . . .			as Directors .	
Salaries and Commission . .			as Executives .	

Where considerable detail has to be given the matter is probably best dealt with in a note, often in tabular form as follows—

The aggregate amounts paid by the Company (and its subsidiaries) to or in respect of the services of the Company's Directors were—

	Directors with Executive Duties	*Other Directors*	*Total*
Fees . . .	—	—	—
Other Emoluments.	—	—	—
Pensions . .	—	—	—

[1] In certain cases consideration must be given to the treatment, both in Profit and Loss Account and Balance Sheet, of Profits Tax Non-distribution Relief and the future liability which may arise therefrom (see *Notes on the Treatment of Profits Tax in Accounts* published by The Institute of Chartered Accountants in November, 1953).

The modern trend in published accounts is to give as much material information as possible in as clear a way as possible. Many companies have experimented with new methods of layout and presentation in an attempt to make the accounts more easily understood by the general public, e.g. "cutting the cake" illustrations to show what proportion of the company's revenue has gone on purchase of raw materials, wages, dividends, taxation, etc.; the use of "conversational" language, and so on. For examination purposes the student is advised to keep to the more usual methods of drafting the Balance Sheet and Accounts, remembering that whatever method of presentation is adopted, they must be clear and lucid and give a true and fair view and, of course, comply with the Companies Act.

A further illustration will be found at the end of the next chapter, incorporating presentation of group accounts.

SECTION (H) DIVIDENDS

A dividend is a division of the profits of a company amongst the members. A dividend cannot be paid unless there are (1) profits and (2) a "declaration."

A dividend may be classified from different aspects—

(1) "Time," i.e. interim or final.

(2) "Priority," i.e. preference, ordinary, deferred.

(3) "Amount," i.e. fixed rate or fluctuating.

(4) "Form," i.e.—

(*a*) Cash.

(*b*) Scrip or specie.

(*c*) Bonus.

(*d*) Subject to tax; free of tax.

(5) "Sanction," i.e. where a dividend may be paid on declaration by directors, or where, as is usual with ordinary dividends, the sanction of the company in general meeting is required.

The following points are essential to a proper understanding of accounting treatment of dividends—

(1) (*a*) An interim dividend may be paid if in the *bona fide* opinion of the directors such a payment is justified, subject to any contrary provision in the Articles. If Table A has been adopted, Clause 115 authorizes such a payment. At any time before its payment, an interim dividend may be cancelled.

(*b*) A final dividend on shares, other than on those carrying a fixed rate (usually preference shares) may be RECOMMENDED by the directors, but must be SANCTIONED by the company in general meeting.

Position of Preference Shares. Directors are not compelled to pay dividends of any kind. It is within their reasonable discretion (subject to the Articles) to build up adequate reserves. If Clause 117 of Table A has not been excluded, the directors may, before recommending *any* dividend, set aside out of the profits of the company such proper reserves for meeting contingencies or for equalizing dividends, or for any other proper purpose, invested inside or outside the business, as they think fit.

(2) Even though a share is a preferred or preference share, it carries no *right* to a dividend (unlike debenture interest) unless the profits have been *earned* and the directors or the company sanctions the payment. The right is not an absolute one: it is at best relative. It merely ensures that a holder of such a share is to be paid a dividend in priority to those holding shares of a lower grade; but unless the share is a [1] *cumulative* preference share, such right of priority is confined to the particular year under consideration. Hence a non-cumulative preference share carries no right to have previous years' omissions made good. Thus, if a company has paid no dividends during a period of, say, four years followed by a successful year, the preference shareholder will obtain priority only for the *current* year's dividend, even though the fifth year's profits are more than sufficient to make up for the "dividendless" years. If, however, the preference shares are cumulative, the holder *is* entitled to receive not necessarily five years' dividends, but to prevent any dividend being paid on a lower grade share unless and until the whole of the five years' dividends are paid to him. Yet, despite this very valuable privilege, the participation in profits is merely a DIVIDEND, and becomes an ENFORCEABLE DEBT against the company only upon its DECLARATION and, where required, after the sanction of the company has been given.

(3) With regard to amount, except that a "fixed" class is restricted to the fixed rate, the *quantum* of the dividend is dependent upon the amount of profits, after making suitable provision for depreciation, taxation, sinking fund contribution, if necessary, the financial resources of the company, the general business conditions ruling, and the normal business requirements of the company.

Position of Partly-paid Shares. The position of partly-paid shares is, as regards dividends—

(*a*) The dividend is payable on the nominal, called-up, or paid-up, amount, according to the provisions of the ARTICLES.

(*b*) If no provision thereon is contained in the Articles, and Table A provisions relating to dividends have not been excluded, and therefore by implication INCLUDED, the dividend is to be based upon the PAID-UP amount according to dates paid, and calls in advance whilst BEARING interest are not to be included for such purpose.

(*c*) If the Articles are silent on the matter and the appropriate provisions of Table A have been EXCLUDED, the basis of the dividend is the NOMINAL amount of the share.

(*d*) The question whether holders of newly issued shares may receive current dividends depends upon the terms of issue, the usual practice being to preclude a payment of a dividend in respect of profits arising in the financial year of issue, but to allow interest on the amounts paid up within the year, although should the issue be

[1] A preference share is *prima facie* cumulative, unless the articles either state otherwise or are repugnant thereto.

made very early in the financial year the terms usually permit the shares to rank for dividend on the full amount paid—as if paid at the commencement of the year.

(4) The dividend may be paid—as is usual—by cash (in practice by dividend warrant), but the company may distribute another form of asset, viz. shares it HOLDS. In this connection it is necessary to observe two very important matters: (*a*) the company actually *distributes* some sort of assets, thus diminishing them to the extent of the dividend; (*b*) a member is entitled to be paid CASH, unless the Articles OTHERWISE provide.

This distribution must be very clearly differentiated from the BONUS Share dividend—commonly called the capitalization of reserves. It would, it may be mentioned, be much more accurate to describe the procedure as the capitalization of reserves and PROFITS. This matter receives consideration on page 966.

Dividends "Free of Tax." Much confusion exists concerning "free of tax" dividends, and attempts are frequently made to justify a differing treatment in the Profit and Loss Appropriation Account, according to the mode of expressing the dividend. Apart from exceptional circumstances, the dividend must ALWAYS be a portion of profits *after* due provision has been made for payment of income tax on the company's profits, so that the recipient of a "free of tax" dividend does not escape the incidence of taxation; not only will he include the dividend received at "GROSS" in his Income Tax Return, but the difference between the gross and the net amount received is available for an income tax repayment in proper circumstances, just as if the dividend were expressed to be paid in the ordinary way.

Further, the principle applies with equal force to ALL dividends, preference or ordinary, fixed or fluctuating, except that in the case of fixed rate dividends a payment on a "free of tax" basis must be duly authorized, as a payment of, say, 5½ per cent "free of tax" is a payment of 10 per cent (subject to tax at 9s. in £); but as ordinary dividends are not fixed (so long as the company in general meeting sanctions it, and not being otherwise invalid), any amount may be paid and any form of expression used.

A "free of tax" dividend is in reality a dividend at a higher rate than one expressed at the same rate subject to tax: thus, a 10 per cent dividend will suffer tax of 9s. in the £, i.e. 4½ per cent, leaving the net dividend at 5½ per cent; so that 10 per cent subject to tax is (at the ruling rate of tax) PRECISELY the same as 5½ per cent "free of tax," and in every respect such a dividend should be treated in the same way, both in the accounts of the company paying the dividend and in those of the recipient, the usual practice being to show dividends "net" in the accounts of the former and "gross" in those of the latter.

As a further manifestation of the importance of this principle,

Sect. 199 of the Income Tax, Act 1952[1], requires to be shown on every dividend warrant the "gross," tax, and "net."

Illustration. Assume X is a shareholder holding 100 shares of £1 each fully paid in a company which pays a dividend of 22 per cent free of tax. The dividend warrant will show the dividend thus—

	£	s.	d.
Dividend on 100 Shares of £1 each fully paid at the rate of 40% per annum	40	0	0
Less Income Tax at 9s. in the £	18	0	0
Net payment, equivalent to 22% free of tax	£22	0	0

Treatment of dividends in accounts will be dealt with under three headings: (*a*) Cash dividends; (*b*) Bonus Share dividends (see page 966); and (*c*) Scrip dividends (see page 974).

Cash Dividends

As the modern practice is to enter dividends net, i.e. after deduction of Income Tax or the actual if "free of tax," the entries in the books of account are—

(1) Debit Profit and Loss Appropriation Account.
Credit Dividend Account with the NET amount.

(A separate Dividend Account will be opened for each class of shares.)

(2) Debit Dividend Account.
Credit Cash (or, in practice, Bank) with the NET amount paid.

Considerable care must be exercised in reading the question containing a dividend declaration, because of the various modes of expression, thus—

If the interim and final dividends are 11 per cent and 22 per cent respectively, both free of tax (9s. in the £), they may be expressed as follows—

(1) 11% free of tax actual and 22% "free of tax" actual
= 33% "free of tax."

(2) 20% subject to tax actual and 40% subject to tax actual
= 60% subject to tax.

(3) At the rate of—
22% "free of tax" for the half-year, and
44% "free of tax" for the half-year } = 33% "free of tax."

(4) At the rate of—
40% subject to tax for the half-year, and
80% subject to tax for the half-year } = 60% subject to tax.

Although the usual practice is to declare dividends consistently, that is, both interim and final dividends, subject to tax or "free of tax," and both actual or "at the rate of," the above dividends might be expressed thus—

(5) At the rate of—
40% subject to tax for the half-year, and 22% "free of tax" actual.

When the final dividend is declared, confusion is likely to arise

[1] Formerly Sect. 33, Finance Act, 1924.

unless the declaration is read with the interim dividend thus—

(1) A final dividend of 22 per cent "free of tax" actual, making with the interim dividend of 11 per cent "free of tax" actual, 33 per cent "free of tax" for the year: these expressions are perfectly clear, but the same final declaration might read—

(2) A final dividend of 22 per cent "free of tax" actual, making with the interim dividend *at the rate* of 22 per cent per annum "free of tax" for the half-year, 33 per cent "free of tax" for the year; or

(3) A final dividend *at the rate* of 44 per cent per annum, making with the interim dividend of 11 per cent "free of tax" actual (or *at the rate* of 22 per cent per annum "free of tax" for the half-year), 33 per cent "free of tax" for the year.

Illustration. The issued share capital of Robot, Ltd., is—

10,000 6% Preference Shares of £1 each fully paid.
20,000 Ordinary Shares of £1 each fully paid.
10,000 Ordinary Shares of £1 each, 16s. called and paid.
4,000 Deferred Shares of 2s. 6d. each fully paid.

The company has £4,800 to the credit of Profit and Loss Account on 31st December, 1953. The preference dividend was paid on 31st December, 1953, and the directors PROPOSED a dividend of

10% on the Ordinary Shares, and
40% "free of tax" on the Deferred Shares

duly SANCTIONED by the company in general meeting on 16th Feb., 1954, the dividend warrants being posted on 18th February, 1954.

Table A (so far as it relates to dividends) has been adopted.

Show Profit and Loss Appropriation Account, ignoring any matters relating to previous dividends, taking tax at 9s. in the £. Ignore Profits Tax.

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT [1] *Cr.*

			£				£
1953 Dec. 31	To Preference Dividend (*less* Income Tax)		330	1953 Dec. 31	By Balance	b/d	4,800
1954 Feb. 16	„ Ordinary Dividend (*less* Income Tax)		1,100				
	„ Ordinary Dividend (*less* Income Tax)		440				
	„ Deferred Dividend (free of tax)		200				
18	„ Balance	c/d	2,730				
			£4,800				£4,800
				1954 Feb. 19	By Balance	b/d	2,730

Participating Preference Shares. There are innumerable ways of participating in the profits of the company, particularly where a share, although preferential as to dividends—with or without being cumulative—also carries a right to a further dividend; thus

[1] Alternatively, all dividends may be shown as paid and proposed respectively at 31st December, 1953, the subsequent entries being made in Dividend Accounts.

Beauchamp Pellets, Ltd., may have participating preference shares —cumulative to 8 per cent, with the right to have a further 2 per cent maximum non-cumulative—if and when the ordinary shares have received 10 per cent dividend.

Illustration. Assume that the profits are £6,000 and there are 20,000 8 per cent cumulative participating preference shares, with participating right to 2 per cent after the payment of a dividend of 10 per cent on the ordinary shares (15,000): all fully-paid £1 shares. The preference dividends are paid half-yearly.

Show Profit and Loss Appropriation Account, taking income tax at 9s. in the £.

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

		£			£
To Dividend on 20,000 8% Preference Shares for Half-year to........(*less* Income Tax)		440	By Balance, being net Profit for Year	b/d	6,000
" do. do. do.		440			
" Dividend on 15,000 Ordinary Shares at 10% per annum (*less* Income Tax) . .		825			
" Participating Dividend on 20,000 8% Preference Shares at 2% (*less* Income Tax) .		220			
" Taxation		?			
" Balance[1]	c/d	?			
		?			£6,000
			By Balance	b/d	?

[The above dividends would be transferred to Dividend Account in the usual way.]

Illustration. If the foregoing participating right attached to preference shares (£20,000) is, say, 50 per cent of the dividends received by the holders of ordinary shares (£15,000) over and above 10 per cent, and the ordinary dividend is 20 per cent, then the latter would be £3,000 gross; and the extra dividend to the preference shareholders $3\frac{3}{4}$ per cent—that is, half of the *excess* the ordinary shareholders receive over 10 per cent. As they receive 20 per cent (£3,000), the "excess" dividend is 10 per cent (£1,500), of which the preference shareholders receive half (£750), which expressed in terms of a percentage is $3\frac{3}{4}$ per cent (£750 = $3\frac{3}{4}$ per cent of £20,000). It is important to observe that the preference shareholders obtain half of such surplus and *not* a dividend of half the excess rate, which would be 5 per cent instead of $3\frac{3}{4}$ per cent. Income tax will be deducted from the dividends on payment.

Bonus Share Dividends

Where a company has accumulated a large Reserve out of profits, instead of distributing such profits by way of cash dividend, it may distribute bonus shares[2] in respect of a part or all of such reserve.

[1] The balance cannot be determined in the absence of the disclosure of the liability for taxation.

[2] Subject to Capital Issues Committee consent if more than £50,000 in any one year.

Apart from the fact that a capital profit not realized is not available for a cash distribution, there are many circumstances preventing or rendering undesirable an actual distribution of cash or other assets by way of dividend.

(1) In a private company, if all the members are really "working partners," the earnings may be used, provided all the legal requirements are carried out, to increase the remuneration of such members, so as to obtain the benefit of earned income allowance for income tax, as the profits of the *company* are considered as unearned and on these no relief for earned income can be claimed.

(2) In all cases, consideration must be given to the liquid position of the company, not only as at the date of the intended dividend, but in the near future. Installation of new machinery and extension of works may be required, in addition to other possible calls upon the liquid funds of the company; whilst the present assets may be "frozen," e.g. in fixed assets, most of which, owing to changing fashions, may have to be scrapped to meet the changed circumstances—radio concern changing over to television—large sums may be locked up in "Shares in and Loans to Subsidiary Companies"; large stocks, which technically are comparatively liquid assets, may be held on a falling market. Proposed changes of a fiscal nature may necessitate larger "cash reserves," thus constraining the company to keep its cash intact; it being an elementary maxim that no borrowing should be made in order to pay a dividend. Again, a sinking fund set aside for debenture redemption represents undistributed profits, although the investment against it may have been sold and utilized to redeem the debentures, so that a bonus dividend may well be made from the sinking fund now "free."

BONUS SHARES

Advantages and Disadvantages. The advantages and disadvantages of an issue of bonus shares are briefly summarized (*a*) as regards the company, and (*b*) as regards the shareholders.

(*a*) *The Company's Viewpoint.* (1) Profits can be distributed without any distribution of the company's assets, or reduction of the additional working capital created by those profits.

(2) If dividends are not largely increased, the distribution of profits over a larger number of shares will reduce the rate of dividend paid. This may be considered expedient to conceal from workers the fact that high dividends are being paid, or to bring the rate more into line with capital employed in the business.

(3) If the company is to maintain the same rate of dividend it must earn larger profits, unless it modifies its reserve policy.

(*b*) *The Shareholder's Viewpoint.* (1) No surtax is payable on a bonus share distribution.

(2) Unless the company makes increased profits, the fall in rate of dividend or depletion of reserves will cause the market price per share to fall—though the total value of the larger holding may be greater.

(3) Speculative dealings in the shares may be caused.

(4) The profits may be distributed in the form of bonus debentures, and subsequently redeemed in cash by the company, thus not attracting sur-tax in the hands of the members but attracting Profits Tax on the "distribution." However, Sect. 21, Finance Act, 1922, Sects. 31 and 32, Finance Act, 1927, Sects. 19 and 20, Finance Act, 1936, Sect. 14, Finance Act, 1937, Sects. 13–16, Finance Act, 1939 (now included in Sects. 245 to 264, Income Tax, Act 1952), provide that certain companies which have not within a reasonable time of the end of their financial year distributed a reasonable part of their profits in such a way as to render such profits liable to be included in the sur-tax assessments of the members, may be assessed for sur-tax thereon by the Special Commissioners.

(5) If the Bonus is applied in reducing or extinguishing the uncalled Capital (e.g. making shares of £1 each, 15s. paid into fully paid £1 shares) there is a distinct tangible benefit to the shareholder.

A bonus share dividend is merely a book entry effected by a transfer from General Reserve[1] or Profit and Loss Appropriation Account to Share Capital—each shareholder receiving a share certificate proportionate to his holding—instead of cash. Thus if the share capital is £8,000 in fully-paid ordinary shares of £1 each and £3,000 is transferred thereto, each shareholder will have the right to an allotment of three new shares for every eight old shares. He is usually given the option of taking up the shares or selling his right of allotment to another person, that is, "renouncing."

As shareholders are entitled to CASH dividends, the sanction of the Articles or special resolution is required for *any* dividend otherwise than in cash, whether it is (*a*) an actual distribution of other assets; or (*b*) a "notional" distribution by way of a bonus share dividend. Income tax is ignored in a bonus share dividend.

Where necessary, fractional certificates or cash must be available if the proposed distribution will involve (as it almost invariably does) giving a fraction of a share to a shareholder; thus in the example just outlined, where three new shares were distributed for eight old, a shareholder may be a holder of 50, so that he is entitled to $\frac{50}{8} \times 3$ shares $= 18\frac{3}{4}$ shares. He would be allotted 18, and given a fractional certificate for three-quarters; or the company may agree to purchase for him a fractional certificate of one-quarter (or more likely $1\frac{1}{4}$ to make his holding a "round" figure) or sell the fraction of three-quarters at market price. (See page 993.)

Unless the bonus involves the disclosure for the first time of a hidden or secret reserve, there is no monetary gain to the shareholder. The price of the share is based upon earning power, and consequently the mere book entry is, as such, not a magic wand to augment the resources of the company or its earning capacity;

[1] Provided that the full amount of the refund had been properly used, the Capital Reserve created by the receipt of E.P.T. Post-war Refund could be capitalized for the purpose of an issue of bonus shares (but see page 543).

and the original holder of 50 shares, now increased, say, to 70, will, just as before, be entitled only to his share of distributable profits. Thus his *rate* of dividend on his 70 will be less than that on his original 50. Hence the market price per share, seeing that it yields a lower *rate*, will tend to decrease proportionately. By the issue of bonus shares there is a larger book capital laying claim to the earnings of the company. In many instances the position of a shareholder is likely to be prejudiced, because his holding of 50 shares may become 55 (e.g. in a "1 for 10" distribution), the total value of which will be the same as his original 50, but in the market the holding becomes an "odd lot" and may, as a consequence, fetch a lower price than a round number like 50. Even if he sells 50, he is still left with five, which is an "odd lot."

It may be necessary to INCREASE the NOMINAL capital to cover the bonus shares issue, e.g. if the issued share capital is £10,000, the bonus share dividend 6,000 £1 fully paid shares and the nominal capital £13,000, it will be necessary to increase the latter and pay capital duty of 10s. per cent on £3,000.

Book-keeping Entries

Upon sanction of the dividend—

(1) Debit Profit and Loss Appropriation Account [or Reserve].
Credit Bonus Share Dividend Account.

Upon the issue of the shares—

(2) Debit Bonus Share Dividend Account.
Credit Share Capital Account

In addition, the return of allotments must be filed with the Registrar of Companies; certificates issued; the Register of Members adjusted; and the appropriate minutes recorded. The Balance Sheet and the Annual Return will show the amended share capital.

Illustration. X, Ltd., declares a bonus share dividend (out of reserve) of 100 per cent, the share capital being 30,000 shares of £1 each fully paid. Show Journal entries.

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		£	£
	Reserve . . . . . . *Dr.*	30,000	
	To Bonus Share Dividend . .		30,000
	Being bonus dividend of 100% sanctioned by resolution of the company in general meeting held [Date]		
	Bonus Share Dividend . . . *Dr.*	30,000	
	To Share Capital . . .		30,000
	Being utilization of bonus dividend in increasing the issued share capital as sanctioned by the company in general meeting held [Date]		

The utilization of a bonus share dividend for the purpose of discharging calls on shares involves the following entries—

(*a*) If Call Account is opened—
(1) *Debit Call Account.*
Credit Share Capital Account.
(2) Debit Profit and Loss Appropriation Account [or Reserve].
Credit Bonus Share Dividend Account.
(3) *Debit Bonus Share Dividend Account.*
Credit Call Account.

(*b*) If Call Account is NOT opened—
(1) Debit Profit and Loss Appropriation Account [or Reserve].
Credit Bonus Share Dividend Account.
(2) *Debit Bonus Share Dividend Account.*
Credit Share Capital Account.

Items in italics cancel out, leaving a final result of—
Debit Profit and Loss Appropriation Account [or Reserve].
Credit Share Capital Account.

From the above it will be perceived that the balance of Profit and Loss Appropriation Account is reduced by the amount by which the share capital is increased, the latter being in the form of a greater sum paid up on the same number of shares already issued, instead of a greater number of shares occasioned by the issue of bonus shares.

Illustration. Stanbury, Ltd., has 10,000 shares of £1 each, 12s. called and paid, and after passing the necessary resolutions, declares a bonus dividend in the form of paying up the 8s. uncalled on the shares. Show Journal entries.

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			£	£
	Final Call . . . . . *Dr.*		4,000	
	To Share Capital			4,000
	Being call of 8s. a share on 10,000 shares per resolution of directors, *vide* Minute Book, p. . . .			
	Profit and Loss Appropriation . . *Dr.*		4 000	
	To Bonus Share Dividend . . .			4,000
	Being bonus dividend sanctioned by resolution of the company in general meeting held [Date]......			
	Bonus Share Dividend . . . . *Dr.*		4,000	
	To Final Call			4,000
	Being utilization of bonus dividend in payment of final call as sanctioned by the company in general meeting held [Date]......			

Where a bonus dividend is to be applied in the issue of share capital at a premium, the following entries are required—

(*a*) If Call Account is opened—
(1) *Debit Call Account.*
Credit Share Capital Account (amount to be credited).
Credit Share Premium Account (premium).
(2) Debit Profit and Loss Appropriation Account [or Reserve].
Credit Bonus Share Dividend Account.

(3) *Debit Bonus Share Dividend Account.*
Credit Call Account.

(*b*) If Call Account is NOT opened—
(1) Debit Profit and Loss Appropriation Account [or Reserve].
Credit Bonus Share Dividend Account.
(2) *Debit Bonus Share Dividend Account.*
Credit Share Capital Account (amount to be credited).
Credit Share Premium Account (premium).

Items in italics cancel out, leaving a final result of—
Debit Profit and Loss Appropriation Account [or Reserve].
Credit Share Capital Account.
Credit Share Premium Account.

Illustration. Wycoller, Ltd., has an issued capital of 20,000 shares of £1 each, 17s. 6d. paid, and resolutions are passed whereby a bonus dividend is declared (*a*) to make the shares fully paid; (*b*) to issue a further 5,000 shares of £1 each fully paid—that is, one for every four held—at 30s. each; and (*c*) to pay a cash dividend equivalent to 20 per cent per annum free of tax for the year on the augmented capital after taking into account an interim of 8 per cent "free of tax" already paid (on the old capital).

The company's Articles provide for dividends on the *paid-up* capital. The profits available for dividend are £12,000.

Show the necessary Journal entries, employing Call Account for (*a*) only. The entries for the interim dividend are not required.

It will be noticed that no mention is made of the NOMINAL share capital, hence a very necessary preliminary assumption must be made and STATED in the answer, viz.: "Assumed that either the nominal capital at the date of the resolution was at least £25,000, or it has been validly increased to that sum."

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			£	£
Final Call . . . . . . *Dr.*			2,500	
To Share Capital				2,500
Being, etc.				
Profit and Loss Appropriation Account[1] *Dr.*			10,000	
To Bonus Share Dividend . . .				10,000
Being, etc.				
Bonus Share Dividend . . . *Dr.*			2,500	
To Final Call				2,500
Being, etc.				
Bonus Share Dividend . . . *Dr.*			7,500	
To Share Capital				5,000
,, Share Premium				2,500
Being issue of ordinary shares of £1 each fully paid at 30s. each to the shareholders in the ratio of one new share for every four held, sanctioned by the company in general meeting				

[1] £2,500 relates to the first part [making the partly paid shares fully paid] and £7,500 to the bonus *issue*. [The entries may be separately recorded.]

JOURNAL—(*contd.*)

			£	£
	Profit and Loss Appropriation Account *Dr.* To Dividend . . . . . . Being final dividend, making with the interim dividend of 8% free of tax, 20% per annum, free of tax, on 25,000 shares of £1 each fully paid sanctioned by the company in general meeting.		3,600	3,600
	Dividend . . . . . *Dr.* To Cash . . . . Being payment of net amount due to shareholders in respect of final dividend after deduction of tax.		3,600	3,600

The final dividend is computed as follows:

	£
As the TOTAL Dividend for the year is 20% (free of tax) on £25,000, it equals	5,000
Less Interim Dividend of[1] 8% free of tax on 20,000 shares, 17s. 6d. called and paid [$\frac{8}{100}$ × £17,500]	1,400
Final Dividend ($14\frac{2}{5}$% actual, free of tax), or 26·18% subject to tax (at 9s. in £)	= £3,600

Illustration. A company issued 25,000 7 per cent Redeemable Preference Shares of £1 each at par. At 30th June, 19. ., the shares are to be redeemed at 22s. a share, and for the purpose of assisting the redemption 15,000 Ordinary Shares of £1 each were issued at par. On the above date 1,000 of the Redeemable Preference Shares had been forfeited for non-payment of the last call of 5s., 800 of which had been reissued as fully paid for 12s. a share. The balance of Profit and Loss Account was £12,100 and the General Reserve £3,000. On the same day as the redemption took place a Bonus Share Dividend was declared of £12,500.

Show the Ledger balances as on 30th June, 19. ., and the Ledger entries relating to the redemption of the Preference Shares, the issue of the Ordinary Shares, and the Bonus Shares.

Dr. 7% REDEEMABLE PREFERENCE SHARE CAPITAL *Cr.*

			£				£
	To Sundry Members .		24,800		*By Balance* . . .	*b/d*	24,800

Dr. ORDINARY SHARE CAPITAL *Cr.*

			£				£
	To Balance . . .	c/d	27,500		By Cash . . .		15,000
					„ Bonus Share Dividend Account .		12,500
			£27,500				£27,500
					By Balance . . .	b/d	27,500

[1] The question does not state that the interim was AT THE RATE OF 8 per cent, but a PAYMENT of 8 per cent

Dr. FORFEITED SHARES *Cr.*

		£			£
To Reserve		150	*By Balance*	b/d	150

Dr. PREMIUM ON SHARES REISSUED *Cr.*

		£			£
To **Bonus Share Dividend**		280	*By Balance*	b/d	280

Dr. PROFIT AND LOSS APPROPRIATION *Cr.*

		£			£
To Sundry Members—Premium		2,480	*By Balance*	b/d	12,100
„ Capital Redemption Reserve Fund		9,620			
		£12,100			£12,100

Dr. SUNDRY MEMBERS *Cr.*

		£			£
To Cash		27,280	By 7% Redeemable Preference Share Capital		24,800
			„ Profit and Loss Appropriation Account — Premium on Redemption		2,480
		£27,280			£27,280

Dr. CAPITAL REDEMPTION RESERVE FUND *Cr.*

		£			£
To Bonus Share Dividend Account		9,800	By Profit and Loss Appropriation Account		9,620
			„ Reserve		180
		£9,800			£9,800

Dr. RESERVE *Cr.*

		£			£
To Capital Redemption Reserve Fund		180	*By Balance*	b/d	3,000
„ **Bonus Share Dividend**		2,420	Forfeited Shares		150
„ Balance	c/d	550			
		£3,150			£3,150
			By Balance	b/d	550

Dr. BONUS SHARE DIVIDEND *Cr.*

		£			£
To Ordinary Share Capital		12,500	**By Capital Redemption Reserve Fund**		9,800
			„ Reserve		2,420
			„ Premium on Shares Reissued		280
		£12,500			£12,500

Alternatively, the Premium on Shares Reissued Account could be left intact and the Reserve Account used to the extent of a further £280, bringing down the balance of £270 (instead of £550).

Dr. CASH **Cr.**

		£			£
To Balance (Capital)	*b/d*	*26,230*	By Sundry Members—Redemption of 24,800 Shares of £1 each at 22s. a Share		27,280
" " (Profit and Loss)	*b/d*	*16,100*	" Balance	c/d	28,050
" Ordinary Share Capital Account		15,000			
		£55,330			£55,330
To Balance	b/d	28,050			

Where Preference Shares have been redeemed the Capital Redemption Reserve Fund may be utilized in paying up unissued shares (whether there has been a fresh issue of shares or not). The new issue of shares for CASH was £15,000, so that £9,800 must be transferred from undistributed profits to Capital Redemption Reserve Fund. As the balance of Profit and Loss Appropriation Account is, after the charge for premium, only £9,620, a further £180 will be transferred from Reserve to Capital Redemption Reserve Fund, bringing it up to £9,800, which may now be used towards the issue of fully paid Bonus Shares of £12,500, the difference of £2,700 coming from Reserve £2,420 and Premium on Shares Reissued £280.

The balance on Forfeited Shares Account may be transferred to reserve, there being no possibility of the issue of the remaining 200 Preference Shares.

The opening balances are in italics, the redemption entries in ordinary type, and the Bonus Share entries in heavy type.

The Cash Account is inserted to assist the student in balancing the accounts.

SCRIP DIVIDENDS

Financial companies frequently distribute dividends in the form of shares or debentures in other companies received for underwriting or for placing shares. The dividend will be paid "free of tax."

As has been mentioned previously, a member of a company is entitled to be paid in cash, unless the articles as originally framed or as altered by special resolution state otherwise. (*Hoole* v. *G.W.R.*: *Wood* v. *Odessa Waterworks Co.*)

Book-keeping entries are—

(1) Debit Profit and Loss Appropriation Account [or Reserve].
Credit Dividend Account (or Scrip Dividend Account).

(2) Debit Dividend Account (or Scrip Dividend Account).
Credit Investment Account.

A practical difficulty arising in scrip dividends is the apportionment of the investments distributed amongst the shareholders and the consequent trouble in dealing with the fractions.

If there is a book profit on the distribution (e.g. a £10 dividend is distributed by scrip of 10 shares of £1 each where less than par or at a premium over cost), such profit should be transferred to Investment Reserve, unless *all* the investments have been distributed or sold; or if not, so much as is required to revalue the remaining shares at nil.

A Capital Reserve may be used to *issue* shares, but not to *distribute* assets, whether Cash or Investments or any other form of assets.

Illustration. The Balance Sheet of Investments, Ltd., is—

BALANCE SHEET AS AT ....

	£		£
Issued Capital—		Sundry Assets . . .	110,000
100,000 Ordinary Shares of £1 each (fully paid) .	100,000	12,500 Shares in X, Ltd. at Cost	25,000
Profit and Loss Account .	35,000		
	£135,000		£135,000

It is resolved at the general meeting that a "free of tax" dividend of 20 per cent be paid, to be satisfied by the issue of 10,000 shares in X, Ltd., at the market value of £2. Assume that the cost of the shares is £2 each. Show Journal entries and write up the Investment Account in the books of Investments, Ltd., to give effect to the foregoing resolution. State the number of shares in X, Ltd., distributed to the holder of ten ordinary shares in Investments, Ltd.

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		£	£
Profit and Loss Appropriation . . *Dr.*		20,000	
To Scrip Dividend			20,000
Being dividend of 20% "free of tax" sanctioned as per resolution dated			
Scrip Dividend . . . . . *Dr.*		20,000	
To Shares in X, Ltd.			20,000
Being satisfaction of the dividend by transfer of 10,000 fully paid shares in X, Ltd. as per resolution dated			

The effect of the dividend is that every holder of ten ordinary shares in Investments, Ltd., will receive one share in X, Ltd.

The Investment Account will be as follows—

Dr. SHARES IN X, LTD. *Cr.*

		Nominal	Capital			Nominal	Capital
		£	£			£	£
To Balance . .	b/d	12,500	25,000	By Dividend . .		10,000	20,000
				,, Balance . .	c/d	2,500	5,000
		£12,500	£25,000			£12,500	£25,000
To Balance . .	b/d	2,500	5,000				

In the case of a scrip dividend, the company may have a profit or loss on book value, as the transaction may be looked upon as analogous to a sale, inasmuch as the dividend (being a liability) is discharged by the transfer of shares. It is usual, however, to credit the profit, if any, to Reserve, and to charge any loss to Profit and Loss Appropriation Account or Reserve.

Illustration. *Where a Loss.* In reference to the preceding illustration, assume that all the shares were distributed in satisfaction of the dividend at a value of £1 12s. a share. The Journal entries are similar to those above. The distribution will be on the basis of one share for every eight held in ordinary shares of the company. The Investment Account will be as follows—

Dr. SHARES IN X LTD. *Cr.*

		Nominal	Capital			Nominal	Capital
		£	£			£	£
To Balance	b/d	12,500	25,000	By Dividend Account.		12,500	20,000
				,, Profit and Loss Appropriation Account [or Reserve] [1]			5,000
		£12,500	£25,000			£12,500	£25,000

Arrangements will have to be made in respect of fractional shares.

Illustration. *Where a Profit.* The share capital of a company is 40,000 shares of £1 each, 15s. paid. A dividend is paid in the form of shares held by the company as an asset, shown in the books as 5,000 shares of £1 each fully paid at cost price (22s.). The present value of the shares is 30s. a share, and a 10 per cent scrip dividend is paid. Table A is adopted, and the necessary resolution in respect of the dividend has been passed. Show Ledger Accounts.

Dr. DIVIDEND *Cr.*

	£		£
To Shares in .... Ltd. at 30s. each	3,000	By Profit and Loss Appropriation Account [or Reserve]	3,000

Dr SHARES IN .... LTD *Cr*

		Nominal	Capital			Nominal	Capital
		£	£			£	£
To Balance	b/d	5,000	5,500	By Dividend Account.		2,000	3,000
,, Reserve—Profit on Appropriation of Shares to Dividend			800	,, Balance	c/d	3,000	3,300
		£5,000	£6,300			£5,000	£6,300
To Balance	b/d	3,000	3,300				

[1] I.e. loss of 8s. a share on 12,500 shares [difference between "sale" 32s. and cost 40s.].

Dr.	RESERVE		Cr.	
				£
			By Shares in . . . Ltd [1]	800

Dividends accruing on the investment and transfer costs are ignored. If the company agreed to pay such costs, the amount thereof would be charged to the reserve.

The three relative positions in regard to dividends may be thus shown.

Illustration.

BALANCE SHEET

	£		£
Share Capital	10,000	Sundry Assets	7,000
Profit and Loss Account	5,000	Investments	5,000
Creditors	2,000	Cash	5,000
	£17,000		£17,000

(1) Result of CASH dividend of 50 per cent—

BALANCE SHEET

	£		£
Share Capital	10,000	Sundry Assets	7,000
Profit and Loss Account	Nil	Investments	5,000
Creditors	2,000	Cash	Nil
	£12,000		£12,000

(2) Result of SCRIP dividend of 50 per cent—

BALANCE SHEET

	£		£
Share Capital	10,000	Sundry Assets	7,000
Profit and Loss Account	Nil	Investments	Nil
Creditors	2,000	Cash	5,000
	£12,000		£12,000

(3) Result of BONUS SHARE dividend of 50 per cent (or 1 for 2)—

BALANCE SHEET

	£		£
Share Capital	15,000	Sundry Assets	7,000
Profit and Loss Account	Nil	Investments	5,000
Creditors	2,000	Cash	5,000
	£17,000		£17,000

[1] I.e. gain of 8s. a share on 2,000 shares [difference between "sale" 30s. and cost 22s.].

It will be observed that (3) Balance Sheet position is similar to, though differing in form from, the original; whilst (1) and (2) Balance Sheet positions show a reduction in assets of £5,000, thus weakening the position of creditors thereby.

There will be stamp duty of 10s. per cent on £5,000 in (3) if the NOMINAL capital prior to the issue of bonus shares was £10,000 only.

Obviously, the 50 per cent dividend may be composed of two or all the elements above, say 20 per cent in cash, 25 per cent bonus shares, and 5 per cent scrip dividend.

Summary of Treatment of Fractional Shares. (*a*) Odd shares may be sold and the proceeds divided amongst the shareholders entitled to the fractions.

(*b*) A fractional certificate may be issued conferring the right to a share certificate if surrendered with sufficient other fractional certificates to make up a full share within a specified time.

(*c*) Arrangements may be made between the various shareholders for the purchase of the shares making up the fractions.

(*d*) Fractions may be avoided by the issue of partly-paid shares, or shares of a low denomination.

Dividends Paid Direct to Bankers. Recently a practice has grown up of paying dividend warrants direct to the banking account of the shareholder (on the necessary authority of the holder being given). As the number of banking institutions is comparatively small, an important economy is effected, because ONE warrant will be paid to each bank representing all the dividends payable to shareholders (on their authority) who have banking accounts with the particular bank, the latter "distributing" the amount amongst its various customers.

Illustration. Thus, if a company has, say, twenty shareholders, and, in response to the request of the company, eighteen of them have signed the form of authorization enabling the company to pay to their bank direct; and assuming eleven have accounts with Barclays (head office or branches) and seven with Midland Bank (head office or branches), the company would need to prepare four warrants only as follows—

(1) Barclays (total Dividends to members banking with Barclays)	11
(2) Midland (total Dividends to members banking with Midland)	7
(3) Individual Member	1
(4) Individual Member	1
	20

Separate Dividend Banking Account. Where the amount of the dividend and numbers of dividend warrants are large, the total NET amount is transferred to a Dividend Bank Account, the dividend warrants being paid therefrom, the debit balance of which (if any) will equal the balance of unpaid dividends. After a lapse of a reasonable period, such an account will be closed and the balance transferred to the general Bank Account or to a Deposit

Account available for the payment of the warrants when presented.

The entries upon the transfer of the cash to the Dividend Bank Account are—

(1) Debit Profit and Loss Appropriation Account Credit Dividend Account	for *net* dividend.
(2) Debit Dividend Bank (or Banking) Account Credit General Bank Account	for *net* dividend.
(3) Debit Dividend Account Credit Dividend Bank (or Banking) Account	for payments of dividend warrants

If after the lapse of a reasonable time dividend warrants are outstanding, the amount is transferred back to the general Bank Account or to a Deposit Account, by a transfer as follows—

(1) Debit (General) Bank or Deposit Account
Credit Dividend Bank Account.

When after this transfer any of the outstanding warrants are presented, the payment will be made out of the general Bank or Deposit Account, the entry being—

Debit Dividend Account
Credit (General) Bank or Deposit Account.

If and when any outstanding dividend is forfeited,[1] the entries are—

(1) Debit Dividend Account.
Credit Reserve (or Profit and Loss Appropriation Account).
(2) Debit (General) Bank Account.
Credit Deposit Account.

No transfer in (2) is required if previously the unpaid dividends were retransferred to general Bank Account.

Alternatively, the balance of Dividend Account may be transferred to an Unclaimed Dividend Account, and (on forfeiture of dividend) the balance transferred to Reserve or Profit and Loss Appropriation Account.

Illustration. Warren Dawlish & Co., Ltd., has an issued share capital of £200,000 in ordinary shares of £1 each fully paid, and makes up its accounts annually to 30th September.

On 30th September, 1952, the following balances (*inter alia*) appear in the books.

	£	
Profit and Loss Account	37,351	*Cr.*
Dividend No. 6	160	*Cr.*
Dividend No. 7	1,212	*Cr.*
Unclaimed Dividends	527	*Cr.*
Dividend Banking Account [i.e. *Dividends Nos. 6 and 7*]	1,372	*Dr.*
Deposit Account—*re* Unclaimed Dividends	527	*Dr.*

[1] In the carrying out of the power of forfeiture, the Directors must act in a strictly constitutional manner, so that the forfeiture, which is a *stricti juris* matter, must be carried out by proper resolution of Directors or otherwise in accordance with the Articles. Striking out from the Balance Sheet of an amount due to a member, of itself, has no legal consequence except that its elimination would be equivalent to a cessation of acknowledgment of indebtedness for the purpose of the Limitation Act.

On 10th January, 1953, a dividend, No. 8 of 16 per cent "free of Tax" was declared for the year ended 30th September, 1952, warrants being dispatched the following day. During the year ended 30th September, 1953, the following warrants were duly presented for payment: Dividend No. 2, £27; No. 6, £124; No. 7, £1,108; No. 8, £31,196; and on 30th September, 1953, the balances on Dividends Nos. 6 and 7 were transferred to Unclaimed Dividends Account.

Show Ledger Accounts in respect of the dividends.

Dr. DIVIDENDS *Cr.*

			No. 6	No. 7				No. 6	No. 7
1953			£	£	*1952*			£	£
Sept. 30	To Sundries (Dividend Banking Account) .		124	1,108	*Sept. 30*	*By Balances* .	*b/d*	*160*	*1,212*
	,, Unclaimed Dividends Account .		36	104					
			£160	£1,212				£160	£1,212

Dr. DIVIDEND No. 8 *Cr.*

1953			£	1953			£
Sept. 30	To Sundries (Dividend Banking Account)		31,196	Jan. 10	By Profit and Loss Appropriation Account .		32,000
	,, Balance .	c/d	804				
		£	32,000			£	32,000
				Oct. 1	By Balance . . .	b/d	804

Dr. UNCLAIMED DIVIDENDS *Cr.*

1953			£	*1952*			£
Sept. 30	To Sundries (Dividend Banking Account)		27	*Sept. 30*	By *Balance* . . .	*b/d*	*627*
	,, Balance	c/d	640	1953 Sept. 30	,, Dividend No. 6 Account . . .		36
					,, Dividend No. 7 Account . . .		104
			£667				£667
				Oct. 1	By Balance . . .	b/d	640

Dr. DIVIDEND BANKING ACCOUNT *Cr.*

1952			£	1953			£
Sept. 30	To *Balance* . . .	*b/d*	*1,372*	Sept. 30	By Dividend No. 2 .		27
1953					,, Dividend No. 6 .		124
Jan. 10	,, (General) Bank Account[1] .		32,000		,, Dividend No. 7 .		1,108
Sept. 30	,, Deposit Account .		27		,, Dividend No. 8 .		31,196
					,, Deposit Account— *Re* Dividend No. 6		36
					Re Dividend No. 7		104
					,, Balance . . .	c/d	804
		£	33,399			£	33,399
Oct. 1	To Balance . .	b/d	804				

I.e. 16% "free of tax" on 200,000 shares.

Dr. **Deposit** *Cr.*

1952 *Sept. 30*	To *Balance* .	*b/d*	£ *527*	1953 Sept. 30	By Dividend Banking Account . .		£ 27
1953 Sept. 30	,, Dividend Banking Account (No. 6) .		36		,, Balance . . .	c/d	640
	,, Dividend Banking Account (No. 7) .		104				
			£667				£667
Oct. 1	To Balance . .	b/d	640				

Notes. When the old dividend warrants *re* Dividend No. 2 are paid the amount is transferred from the Deposit Account to the Dividend Banking Account, and the actual payment made out of the latter account and debited to Unclaimed Dividends Account. As the Dividend Banking Account at the commencement (£1,372) is reflective of Dividends Nos. 6 and 7, the payments out of this Banking Account are debited to Dividends No. 6 and No. 7 Account; then when the final balances thereon are "lifted" to Unclaimed Dividends Account there must be a corresponding transfer from Dividend Banking Account to Deposit Account.

Whenever the unclaimed dividends are written off as profit, the amount represented thereby will be transferred from the Deposit Account to the General Bank Account.

Actually the company would require production and verification before the warrants in respect of Dividend No. 2 were paid, as such warrants would be considered "stale."

Opening entries are in italics.

If the payment of £27 is not utilized out of the Deposit Account, the Deposit Account would be the opening balance of £527 and an "in" transfer of £113 instead of £140, leaving the balances the same. The method shown in the text is considered preferable so as to keep identified each transfer from Dividend Banking Account to the Deposit Account.

Dividend Equalization Fund or Reserve. This is a reserve built up out of profits for the purpose of attempting to maintain a steady and unfailing yearly dividend. It is an " internal " reserve, an appropriation of profits of a voluntary nature, for a specific purpose. Entries in Journal form are —

(1) On creation of Reserve—
Profit and Loss Appropriation Account. *Dr.*
To Dividend Equalization Reserve

(2) On utilization—
Dividend Equalization Reserve. *Dr.*
To Dividend Account.

(3) On payment—
Dividend Account. *Dr.*
To Bank.

SECTION (I) RECONSTRUCTIONS, AMALGAMATIONS, AND ABSORPTIONS

Before proceeding with the accounting records arising out of the above, it is important that the precise meaning attached to the terms be understood. An amalgamation in its broadest conception means the combination of two (or more) companies into one by—

(1) An absorption of one concern by another, the procedure in which is to wind up the former (known as absorption); or

(2) A formation of an entirely new company to acquire the separate concerns, necessitating the winding up of the latter. This procedure is known as an amalgamation (in its narrower sense).

(3) The formation of a holding company to acquire the SHARES in the concerns in question, in which case not only is a new company formed, but the constituent companies remain.

(4) The exchange of shares of one company with those of another, in which case the old companies remain unchanged and, as contrasted with (3), no new company is formed, the merging process being effected by an exchange of shares, e.g. A company acquires a block of shares in B company, the latter at the same time acquiring a block of shares in A company.

A reconstruction, the purpose of which will be noted shortly, may take the form of an internal reorganization of capital or the inauguration of a new company, the latter acquiring the assets and assuming the liabilities of the former company, the second procedure often being designated an external reconstruction.

The various positions may be illustrated by reference to two imaginary companies, A and B.

(1) If an amalgamation takes place, there are two liquidations (i.e. A and B) and the formation of a new company, say, C.

(2) If an absorption takes place, there is one liquidation (say, A) and no new company formed.

(3) If an amalgamation takes place by means of a holding company there is no liquidation, but (unless such company is already in existence) a formation of a new company.

(4) If an amalgamation takes place by means of share exchange, there is neither liquidation nor formation involved.

(5) If there is an external reconstruction, there is a liquidation, say, of A, superseded by the formation of a new company, say, C.

There are thus—

(1) *Two* liquidations and *a* formation	=	AMALGAMATION.
(2) *One* liquidation and *no* formation	=	ABSORPTION.
(3) *No* liquidation and *a* formation	=	NEW HOLDING COMPANY.
(4) *No* liquidation and *no* formation	=	SHARE EXCHANGE.
(5) *One* liquidation and *a* formation	=	EXTERNAL RECONSTRUCTION.

Having noted what may be called the "mechanical" side of these mergers, it is necessary to remind the student of the "legal" side, and careful reference should be made to the subject-matter in a law textbook.

The chief objects of amalgamation are—

(1) To eliminate or minimize competition.

(2) To pool resources, whether financial or technical, facilitating the best utilization of staff, and development of research.

(3) To effect general economies in (*a*) production, (*b*) use and power of capital, (*c*) selling, (*d*) distribution, and (*e*) general overheads through centralization and closing down unprofitable and redundant sections.

(4) To create a more powerful economic unit to control markets, supplies of materials; to effect purchases on a larger scale and, consequently, at generally lower prices and on more advantageous terms; to combat the demands of trade unions, and to exercise more political influence in commercial matters, e.g. as to tariffs, etc.; to create by the augmentation of the issued capital a larger market for share dealings and the raising of further capital.

The objections to amalgamations are—

(1) Anti-social factors involving exploitation of the public, creating monopolistic conditions of price inflation, withholding of supplies, creation of artificial shortages and, in wartime, the danger to the State through adherence to Cartel arrangements.

(2) Political objections from Trade Unions.

(3) Disappearance of the small trader and therewith the loss of the personal element.

(4) The danger of amalgamation of businesses which are best left in their present form and structure.

(5) The possible loss of valuable goodwill through disappearance of the names of old proprietors, although the utilization of the Holding Company will largely overcome this.

(6) Over-centralization involving loss of control, lack of cohesion in management, unwillingness of directors and high executives to lose their "sovereignty."

(7) Over-capitalization through the watering of capital by promoters and vendors (this applies particularly to extravagant prices paid for goodwill of businesses purchased in boom periods).

(8) Scope is given to unscrupulous promoters.

The fact may also be mentioned that nationalization of large units of industry is facilitated by prior amalgamations, but this is a matter which depends upon the political inclination of the individual.

Amalgamations may have substantial effects on taxation liabilities when they involve the technical cessation and commencement of businesses. This applies particularly to income tax savings following reconstructions during trade recessions. Such savings may, however, be offset in certain cases by profits tax distribution charges unless the consideration for the transfer of the trade or business consists wholly or mainly of shares and election can be made under sect. 36 (4), Finance Act, 1947.

The above objects may be reached by the operation of an entirely new and substituted company; or by an absorption; or by the formation of a holding company; or by an exchange of shares. In the second case the stronger usually takes over the weaker.

In reconstruction, which, as has been already stated, may be (*a*) external, involving a winding up, and a new company being

formed; or (*b*) internal, not involving winding up, the objects are:

(i) Compromise with creditors (including debenture holders).

(ii) Compromise with members by alteration of various rights between each class, usually involving the writing down of the amount of share capital (as in a reduction of capital, which is a special form of reconstruction).

(iii) The raising of further capital from members, obviously only where shares are fully paid, as if they are partly paid a call will be made in the ordinary way.

(iv) Alteration of domicile (external reconstruction).

(v) Alteration of Memorandum.

(vi) Decentralization whereby mere sections, branches, or departments become self-contained units.

It is important that the student should observe whether the reconstruction has become necessary or is merely advisable. A necessary reconstruction almost invariably involves the alteration of rights, or the imposition of some sacrifice, temporary or permanent, on both members and creditors.

Before proceeding with the principles involved in merger and reconstruction operations, it may be here remarked that examination questions in this department of accounting are very popular—at least with the examiners; and a very thorough comprehension of the principles and rules is imperative. The questions may be broadly divided into two types—

(*a*) The "mechanical" or mere book-keeping problem.

(*b*) The "diagnosis and cure" or "accounting" problem.

The latter problems are infinitely more difficult than the former, involving, as they do, not only the knowledge of the mere book-keeping entries, but a wide knowledge of business affairs, business psychology, finance, and even political and technical matters. The book-keeping entries will first be disposed of.

Closing Entries on Liquidation. (1) Debit Realization Account with assets other than fictitious assets taken over; credit the individual Asset Accounts.

(2) Debit provisions like bad debts provision (which, although deducted from assets, are CREDIT balances); credit Realization Account.

(3) Debit liabilities and *if taken over* credit Realization Account. If to be *paid* by the company, liabilities will remain untransferred in the books, and upon payment the accounts will be debited and cash credited. The above term "liabilities" includes debentures.

(4) Debit purchasing company and credit Realization Account with the purchase consideration, the ascertainment of which being frequently the most difficult part of the problem.

(5) Debit Realization Account with expenses of realization; credit cash.

(6) Debit cash, shares, or other assets paid in discharge of the purchase consideration; credit the purchasing company.

(7) The balance of Realization Account will be closed by a transfer to Sundry Members' Account.

(*a*) If a profit: debit Realization Account; credit sundry members.

(*b*) If a loss: debit sundry members; credit Realization Account.

(8) Debit share capital and credit sundry members with share capital.

(9) Debit general reserve (and other accounts of undistributed profits); credit sundry members.

(10) Debit sundry members and credit fictitious assets, including debit balance on Profit and Loss Account.

(11) Debit sundry members and credit cash, shares, or other assets as paid to them (according to circumstances), remembering that cash may already be diminished by the payment of liabilities and expenses of realization.

Where there are different classes of members, the transfers will vary according to the nature of the item and the particular rights of each class, so that it will be essential to have separate Members' Accounts for each class, e.g. preference, ordinary, deferred.

The following points may arise (numbers in parentheses refer to the foregoing entries)—

(1) Where cash is not taken over—and usually the arrangement is for the cash to be retained by the acquired company—the purchase consideration being accordingly diminished, no entry will be required, the balance remaining in the Cash Book. Where certain assets are not acquired by the purchasing company but sold piecemeal, the selling company will debit them to a separate Realization Account in the ordinary way; or by leaving the assets untransferred, crediting them with cash received, and transferring the balance of each separate asset to Realization Account as representing a profit or loss on each asset disposed of. Where the selling company has sufficient cash to pay creditors, the purchase consideration will usually be based on assets only.

(2) Where debentures are to be redeemed at a premium by the *purchasing* company, the alternative methods may be—

(*a*) Debit debentures; credit Realization Account, ignoring all considerations of premium, as the acquired company is relieved entirely of its burden, the amount of which will normally appear in the books at the nominal value.

(*b*) Where the selling company receives the cash from the purchasing company, the debentures will not be transferred to Realization Account, as in (*a*), but as follows: debit Realization Account and credit debentures with the premium.

Alternatively, the entries in (2*b*) may be effected through the Debenture-holders' Account.

(3) Any profits or losses connected with the discharge of liabilities will be (*a*) in case of profits, debited to liabilities and credited to Realization Account; and (*b*) in case of losses, debited to Realization Account and credited to the liabilities.

The disposition of certain items appearing in the books of the absorbed company requires careful consideration.

As will be remembered assets and liabilities taken over will be dealt with through the transfer to Realization Account, but such debit items that appear as assets will, if they are fictitious, e.g. Discount on Debentures, Preliminary Expenses and Profit and Loss Account (if the losses have exceeded gains) be transferred to the debit of Sundry Members, and credit items like Share Capital and Profit and Loss Account will be transferred to the credit of Sundry Members.

It is, however, the items described as Reserves, Provisions and Funds that give the most trouble, but the principle is simple. Is the item a liability, or an undistributed profit (i.e. a provision or a reserve)? Or does it include both? If a liability it will be either taken over or discharged. In the former case it will be transferred to Realization Account; in the latter case it will be paid off in the ordinary way. If, however, the item is undistributed profit it will be transferred to Sundry Members.

In addition, items which are provisions against loss or depreciation of assets are similar to liabilities (except that they cannot, as such, be taken over by the absorbing company, although the latter could introduce into their opening entries exactly the same provision figure). Therefore they are equivalent to a liability no longer required as the assets in respect of which they were created will be taken over by the absorbing company, so that they will be transferred to Realization Account. Typical of such items are Amortization Funds, Bad Debts Provisions, Depreciation Funds, Leasehold Redemption Funds.

Where items partake of both liabilities and undistributed profit, e.g. Workmen's Compensation Fund, that part representing liability will be dealt with in the way mentioned above, that is, if taken over will be credited to Realization, or if paid off, will be dealt with as for any other liability paid, i.e. credit to Cash or Bank. It is important to understand that items like that will have been built up normally as provisions for likely liabilities, and if excessive, will be a secret reserve, but the true nature must be ascertained and dealt with on a sale of the company.

The four fundamental rules are—

(1) If provision for a liability not required, the credit is to Realization Account.

(2) If undistributed profit, the credit is to Sundry Members.

(3) If a "mixed" fund, the credit will be (*a*) to Realization Account as to the part representing a liability (or provision against loss or depreciation of an asset), and (*b*) to Sundry Members as to the part representing undistributed profit.

(4) If a debit balance of Profit and Loss or a fictitious asset the debit will be to Sundry Members.

The following is a summary of the treatment of Reserves, Provisions and Funds—

Credit Balance	Nature	Treatment
(1) General Reserve	Undistributed profit	Credit Sundry Members.
(2) Provision	Provision for loss—equivalent to liability	Credit Realization Account (liability not maturing)
(3) Leasehold Redemption	Provision for depreciation—equivalent to liability	Do.
(4) Debenture Redemption	Undistributed profit (held back in accordance with Debenture Trust Deed).	Credit Sundry Members.
(5) Rehabilitation Fund	Provision for meeting expenses of deferred repairs, renewals, additions, replacements.	Credit Sundry Members for the Capital portion of replacements of and additions to Assets, e.g. Plant Credit Realization Account for the Revenue portion, e.g. repairs and renewals.
(6) Workmen's Profit Sharing Fund	Liability to workpeople	If taken over, Credit Realization Account; if paid off (as probable), credit Cash or Bank.
(7) Insurance Funds Fire, Marine, Workmen's Compensation	Undistributed profit and Liability (The excess of the Fund over Liabilities (*b*) will be undistributed profit (*a*).)	(*a*) Credit Sundry Members. (*b*) As in (6).
(8) Contingencies Reserve	As 7	As 7
(9) Capital Reserve	Profit not of a distributable nature	Credit Sundry Members.

Illustration. [*External Reconstruction.*] G, Ltd., agrees to reconstruct by forming a new company, G (1952), Ltd., to which the business is sold, the purchase consideration therefor being the issue of 100,000 shares of £1 each, credited as 5s. per share paid. For the purpose of sale, sundry assets are to be valued at £40,000.

The Balance Sheet of G, Ltd., at the date of sale was as follows—

G. Ltd., Balance Sheet as at . . . .

	£		£
Authorized and Issued Share Capital	55,000	Sundry Assets . . .	62,000
Liabilities . . .	15,000	Profit and Loss Account .	8,000
	£70,000		£70,000

Assuming that the liabilities are taken over by G (1952), Ltd., close the books of G, Ltd., ignoring realization expenses.

Dr. REALIZATION ACCOUNT *Cr.*

	£			£
To Sundry Assets[1] . .	62,000	By Sundry Creditors[1]. .		15,000
		,, G (1952), Ltd.. Purchase Consideration . .		25,000
		,, Loss on Realization		22,000
£	62,000		£	62,000

Dr. SUNDRY MEMBERS *Cr.*

	£			£
To Profit and Loss Account[1]	8,000	By Balance[1] .		55,000
,, Loss on Realization	22,000			
,, Shares in G (1952), Ltd	25,000			
£	55,000		£	55,000

Dr. [2] G (1952), LTD. *Cr.*

	£		£
To Realization Account .	25,000	By Shares	25,000

Dr. [2] SHARES IN G (1952), LTD *Cr.*

	£		£
G (1952), Ltd. .	25,000	By Sundry Members .	25,000

Competing Claims of Members. Where there are several classes of members, their rights as between themselves depend upon the **Memorandum** and **Articles of Association.** Where no specific reference is made therein, the rights are dependent upon circumstances.

(1) Where Preference Shares have priority as to repayment of Capital in a winding up calls must be made on shares of a junior class (e.g. ordinary shares) if not fully paid, in order to meet the Preference priority.

(2) It may happen that of shares of the same class some may be fully paid, some partly paid and/or some with calls in advance. The latter are treated as *debts* and must be paid off before the others and, where necessary, calls made on the partly paid shareholders.

Where there are calls in arrear the holders thereof are not entitled to any share in a distribution until the non-defaulting shareholders have been paid sufficient to equate the position, that is, to make all the shares (of the same class), the same amount paid up.

In practice, a full call will not usually be necessary, but only sufficient to enable such dividend to be paid on the fully paid shares as will leave all the shares of the same class with the same amount paid up.

[1] Inserted direct from Balance Sheet.

[2] In examination work these accounts may be dispensed with.

(3) If there is a preference as to dividends, it is *prima facie* cumulative, but on a winding up arrears of preference dividends do not necessarily accrue to the preference shareholders. If, however, the Memorandum or Articles entitle the preference shareholders to the arrears of preference dividend, they will be entitled thereto, unless the clause is qualified by special words, e.g. dividends DUE, in which case the preference shareholders would not be entitled to the arrears, unless dividends have been DECLARED.

(4) Where preference shareholders are entitled to priority of repayment of capital, they are not entitled to share *pari passu* with ordinary shareholders in a surplus unless expressly authorized by the Articles. The onus is on the preference shareholders to prove that they have such a right.

The trend of judicial ruling following the 1933 case of *William Metcalfe & Sons, Ltd.*, that preference and ordinary shareholders were *prima facie* on a *pari passu* footing as regards a surplus seems to have been reversed in *Scottish Insurance Corporation* v. *Wilson's & Clyde Coal Co., Ltd.* (1949). To afford some protection to preference shareholders against repayment at a price with or without premium below the current market price, they are now often given the right to repayment with a premium fixed by reference to the average price on the London Stock Exchange during a period of, say, six months prior to the relevant date.

The members, however, may agree to take shares instead of a cash payment, so that it is immaterial what profit or loss on realization arises, as the DEBIT to each class of member is fixed at the outset; but as the Realization Account must be closed, the balance will be split according to the balances on the accounts of the members, thus constituting merely a balancing item.

Illustration. [*External Reconstruction.*] The Balance Sheet of D, Ltd., is as follows—

D, LTD., BALANCE SHEET AS AT......

		£		£	£
Authorized and Issued Share Capital—			Fixed Assets—		
50,000 6½% Preference Shares of £1 each, fully paid		50,000	Patents	24,500	
			Freehold Property	60,000	
60,000 Ordinary Shares of £1 each, fully paid		60,000			84,500
5% Debentures	£10,000		Current Assets—		
Add Interest accrued	2,000		Cash	500	
		12,000	Debtors	12,000	
			Stock	18,000	
Creditors		8,000			30,500
			Profit and Loss		15,000
		£130,000			£130,000

The following scheme was passed and sanctioned—

(1) X, Ltd., to be formed to take over the business.

(2) One share of 10s. fully paid in the new company to be issued for every three ordinary shares in the old company.

(3) Three shares of 10s. fully paid in the new company to be issued for every five preference shares in the old company.

(4) Debenture holders to be paid in full by X, Ltd.

(5) The creditors to receive 80 per cent of the sums due to then in fully-paid shares of 10s. in the new company in full settlement.

(6) Patents and Profit and Loss Account to be written off.

(7) Arrears of preference dividend to be cleared by issuing one 10s. fully-paid preference share in X, Ltd. for every twenty held.

(8) Any balance available by the scheme to be used in writing down the freehold property.

Show closing and opening Journal entries. Ignore expenses.

D, Ltd., Journal

		£	£
Realization Account . . . . . *Dr.*		90,500	
To Freehold Property			60,000
,, Stock			18,000
,, Debtors			12,000
,, Cash			500
Being sundry assets taken over by X, Ltd., in accordance with reconstruction scheme.			
5% Debentures . . . . . *Dr.*		12,000	
To Realization Account			12,000
Being debentures taken over, etc.			
X, Ltd. . . . . *Dr.*		32,650	
To Realization Account			32,650
Being purchase consideration under reconstruction scheme.			
Preference Share Capital . . . . *Dr.*		50,000	
Ordinary Share Capital . . . . *Dr.*		60,000	
To Sundry Members			110,000
Being share capitals transferred to sundry members.			
Reconstruction Account . . . . *Dr.*		45,850	
To Realization Account			45,850
Being loss on realization.			
Shares in X, Ltd. . . . . . *Dr.*		32,650	
To X, Ltd.			32,650
Being discharge of purchase consideration.			
Sundry Members (Preference) . . . *Dr.*		16,250	
,, ,, (Ordinary) . . . *Dr.*		10,000	
Creditors . . . . *Dr.*		6,400	
To Shares in X, Ltd.			32,650
Being discharge of liability under reconstruction scheme.			
Reconstruction Account . . . . *Dr.*		1,250	
To Sundry Members (Preference) .			1,250
Being discharge of arrears of preference dividends by distribution of one share for 20 preference shares under scheme of reconstruction.			

D, LTD., JOURNAL—(*contd.*)

		£	£
Reconstruction Account . . . . *Dr.* To Patents . . . . . ,, Profit and Loss Account . . Being debit balances written off under scheme of reconstruction.		39,500	 24,500 15,000
Sundry Creditors . . . . *Dr.* To Reconstruction Account . . Being amount written off sundry creditors under reconstruction scheme.		1,600	 1,600
Sundry Members (Preference) . . *Dr.* ,, ,, (Ordinary) . . *Dr.* To Reconstruction Account . . Being balance of Reconstruction Account written off to sundry members.		35,000 50,000	 85,000

The more important Ledger accounts are—

Dr. SUNDRY MEMBERS *Cr.*

		Preference	Ordinary			Preference	Ordinary
		£	£			£	£
To *Reconstruction Account* . .		*35,000* [1]	*50,000* [1]	By Share Capital Account .		50,000	60,000
,, Shares in X, Ltd. .		16,250	10,000	,, Reconstruction Account .		1,250 [1]	
		£51,250	£60,000			£51,250	£60,000

As the transfer to sundry members is merely a balancing figure, the transfers from the Share Capital Accounts may be made to one account for Sundry Members, thus—

Dr. SUNDRY MEMBERS *Cr.*

		£			£
To Reconstruction Account .		85,000	By Share Capital Accounts:		
,, Shares in X, Ltd.:			Preference . . .		50,000
Preference Shareholders .		16,250	Ordinary . . .		60,000
Ordinary Shareholders .		10,000	,, Reconstruction Account .		1,250
		£111,250			£111,250

Dr. RECONSTRUCTION ACCOUNT *Cr.*

		£			£
To Preference Shareholders [1] .		1,250	By Sundry Creditors		1,600
,, Sundry items written off .		39,500	,, *Sundry Members*—		
,, **Realization Account** . .		**45,850**	*Preference* . *£35,000* [1]		
			Ordinary . *50,000* [1]		*85,000*
	£	86,600		£	86,600

[1] As the transfer to sundry members is merely a balancing figure, a frequent practice is to transfer the amount written off share capitals to Reconstruction Account without employing the account for Sundry Members. This would avoid the transfers above indicated, whilst the Journal entries in respect of the shares paid to members and the share capital transfers would be modified accordingly.

Dr. REALIZATION ACCOUNT *Cr.*

	£		£
To Sundry Assets	90,500	By 5% Debentures of X, Ltd.	12,000
		,, X, Ltd.—Purchase Consideration	32,650
		,, **Reconstruction Account**	**45,850**
	£90,500		£90,500

Dr. CREDITORS *Cr.*

	£		£
To Realization Account	1,600	By Balances	8,000
,, Shares in X, Ltd.	6,400		
	£8,000		£8,000

Dr. X, LTD. *Cr.*

	£		£
To Realization Account	32,650	By Shares	32,650

Dr. SHARES IN X, LTD. *Cr.*

	£		£
To X, Ltd.	32,650	By Sundry Members—	
		Preference	16,250
		Ordinary	10,000
		,, Creditors	6,400
	£32,650		£32,650

If all the adjustments appear in one account, e.g. the Realization Account, the transfer of £85,000 to the debit of Sundry Members would be arrived at thus—

Dr. REALIZATION ACCOUNT *Cr.*

	£			£
To Sundry Assets	90,500	By 5% Debentures		12,000
,, Preference Shareholders	1,250	,, Sundry Creditors		1,600
,, Sundry items written off: [Patents and Profit and Loss Account]	39,500	,, X, Ltd.: Purchase Consideration		32,650
		,, Sundry Members:		
		Preference	£35,000	
		Ordinary	50,000	
				85,000
	£131,250			£131,250

As a result the transfer previously shown in heavy type would not be necessary.

ALTERNATIVE METHOD.

Dr. RECONSTRUCTION ACCOUNT *Cr.*

	£		£
To Preference Shareholders	1,250	By Share Capital Accounts written off—	
,, Sundry items written off	39,500	Preference	35,000
,, Realization Account	45,850	Ordinary	50,000
		,, Sundry Creditors	1,600
	£ 86,600		£ 86,600

Dr [1] SHARE CAPITALS Cr

	Preference	Ordinary		Preference	Ordinary
	£	£		£	£
To Reconstruction Account	35,000	50,000	By Balances	50,000	60,000
Shares in X, Ltd	16,250	10,000	,, Reconstruction Account	1,250	
	£51,250	£60,000		£51,250	£60,000

The purchase consideration is arrived at as follows—

		Shares @ 10s each	£
Shares to be issued to—			
(1) Ordinary Shareholders		20 000	10,000
(2) Preference Shareholders	Shares		
(a) for Capital .	30,000		
(b) for "Arrears" of Dividends	2,500	32 500	16,250
(3) Creditors (80% of £8,000 = £6,400)		12,800	6,400
Total . . .		65,300	£32,650

The opening Journal entries for X, Ltd. are—

		£	£
Freehold Property[2]	Dr	14,150	
Stock . .	Dr	18,000	
Debtors . . .	Dr	12,000	
Cash	Dr	500	
To Debenture Holders of D, Ltd			12,000
,, D, Ltd (Vendor) .			32,650
Being sundry assets and debentures taken over and purchase consideration as per agreement dated			
D, Ltd (Vendor)	Dr	32,650	
To Share Capital			32 650
Being discharge of purchase consideration by allotment of 65 300 shares of 10s each fully paid, as per agreement and directors' resolution, *vide* Minute Book, p			

Share Fractions. It may not be possible to give an exact allotment owing to fractions arising from the basis of the exchange; thus, assuming an exchange of seven shares in the new company for every four in the old, Y, a member holding 25 ordinaries, would theoretically be entitled to $\frac{7}{4} \times 25$ shares in the purchasing

[1] In the alternative method these accounts take the place of Sundry Members Account [See page 991.]

[2] This is a balancing figure (see paragraph 8 in question) It reflects the loss on realization of the old company £45,850 as the book value of the property in the old books is £60,000 and in the new books £14,150

company, or 43¾ shares. But, as fractions of shares cannot be issued, the usual procedure is either—

(1) to sell the shares not capable of allotment and divide the proceeds amongst those entitled to the fractions, or

(2) payment of cash to cover the original shares not divisible into whole shares, on the basis of market price of the shares to be allotted or on the basis of the paid up value of either the exchanged shares or the new shares, or

(3) to issue—in big scale share exchanges—fractional certificates. The holder may then—

(*a*) sell them,
(*b*) buy sufficient to make up a "full" share, or
(*c*) pay cash to make his fractions "full."

Before this can be carried out, a full list of members must be prepared, because, although the TOTAL exchange will probably obviate fractions, it is very unlikely that the individual exchanges will.

Illustration. The Issued Share Capital of Beer, Ltd. is £10,000; that of Skittles, Ltd. £4,000, all divided into shares of £1 each, fully paid.

It is arranged that Beer, Ltd. should take over the shares of Skittles, Ltd. by issuing shares (of £1 each fully paid) to the shareholders of the latter company on the basis of their respective values viz. Beer, Ltd. 32s. and Skittles, Ltd. 20s.

The shareholders all hold shares capable of exact exchange, i.e. 8 or multiples of 8, totalling 3,560, except 5 shareholders holding respectively A 23, B 74, C 100, D 118, and E 125.

Show how the exchange will be dealt with in the books of Beer, Ltd., including fractions.

DIVISION

	Original Shares		Shares in Beer, Ltd.	
Sundry shareholders holding 8 or multiples of 8	3,560		$\frac{5}{8} \times 3{,}560$	2,225
Other holdings—				
A		23	$\frac{5}{8} \times 23$	$14\frac{3}{8}$
B		74	$\frac{5}{8} \times 74$	$46\frac{1}{4}$
C		100	$\frac{5}{8} \times 100$	$62\frac{1}{2}$
D		118	$\frac{5}{8} \times 118$	$73\frac{3}{4}$
E	440	125	$\frac{5}{8} \times 125$	$78\frac{1}{8}$
	4,000			2,498
			Fractions	2
				2,500

The number of shares to be issued by Beer, Ltd. is $\frac{20}{32}$ ($\frac{5}{8}$) of 4,000 = 2,500. Ignoring other factors that would probably exist, this puts the shareholders of Skittles, Ltd. in the same position as before, viz.—

		£
4,000 Shares (Skittles, Ltd.) at par	=	4,000
2,500 ,, (Beer, Ltd.) at 32s.	=	4,000

The amount due to "other" shareholders for fractions may be discharged—

(1) By Cash payments amounting to £2, e.g. to (A) 7s. 6d. etc.

(2) By Cash equivalent to shareholding, i.e. $\frac{8}{5} \times$ £2 = £3 4s. e.g. to holder of 23 shares $\frac{8}{5} \times$ 7s. 6d. = 12s. (the arithmetic equivalent of holding $\frac{3}{8}$ of a share worth 32s.).

(3) Cash payments on unexchangeable shares, i.e. 2 @ £1 = £2.

Thus the purchase consideration would be the allotment of 2,498 shares plus Cash payments amounting to (*a*) £2 or (*b*) £3 4s. being 32s. a share for 2 shares.

Alternatively, the shares could be divided by 8, leaving the undivisible shares as fractions and discharging the latter by the above method.

This would be—

		Original Shares	Exchangeable Multiple of 8		Balance not Exchanged	Shares in Beer, Ltd.
Sundry shareholders .		3,560		3,560		2,225
Other shareholders—						
A . .	23		16		7	10
B . .	74		72		2	45
C . .	100		96		4	60
D . .	118		112		6	70
E . .	125		120		5	75
	——	440	—	416		
		4,000		3,976	24	2,485

This would result in issuing 2,485 shares in Beer, Ltd. to shareholders of Skittles, Ltd. and cash payments of

(*a*) £24, as above (e.g. £7 to A, etc).

(*b*) £38 8s. i.e. $\frac{8}{5} \times$ £24 (i.e. 32s. for each unexchanged share) thus—

	£	s.	d.
A would receive Cash	11	4	0
B ,, ,, ...	3	4	0
C ,, ,, ...	6	8	0
D ,, ,, ...	9	12	0
E ,, ,, ...	8	0	0
	£38	8	0

(*c*) as in (*a*). No difference arises here because the shares of both companies are £1 fully paid.

Thus, the purchase consideration would be the allotment of 2,485 shares and cash payments amounting to (*a*) £24 or (*b*) £38 8s., being 24 unexchangeable shares of 32s. each.

Illustration. [*Absorption.*] Hebden, Ltd., sells its business to Bridge, Ltd., the latter to take over the assets at book values and pay creditors; *in addition,* it is to pay Hebden, Ltd., £100 towards redemption of its debentures at a premium of 10 per cent. The payment of purchase price is to be £2,000 in shares of £1 each at par and the balance in cash.

BALANCE SHEET (HEBDEN, LTD.)

	£			£
Issued Capital	3,000	Sundry Assets		5,200
Profit and Loss Account	300	Debtors	£1,700	
Creditors	2,450	*Less* Provision	150	
Debentures	1,000			1,550
	£6,750			£6,750

Show entries in the books of Hebden, Ltd.

Ignore realization expenses and the question of the possible increase of the nominal capital of Bridge, Ltd.

Entries in Ledger form in the books of Hebden, Ltd.—

Dr. REALIZATION ACCOUNT *Cr.*

	£			£
To Sundry Assets	5,200	By Bad Debts Provision		150
,, Debtors	1,700	,, Creditors		2,450
,, Premium on Debentures	100	,, Bridge, Ltd., Purchase Consideration		4,550
,, Profit on Realization	150			
	£7,150			£7,150

Dr. BRIDGE, LTD *Cr.*

	£			£
To Realization Account	4,550	By Shares		2,000
		,, Cash		2,550
	£4,550			£4,550

Dr. DEBENTURES *Cr.*

	£			£
To Cash	1,100	By Balance	b/d	1,000
		,, Premium		100
	£1,100			£1,100

Dr. SUNDRY MEMBERS *Cr.*

	£			£
To Cash[1]	1,450	By Share Capital		3,000
,, Shares[1]	2,000	,, Profit and Loss Account		300
		,, Realization Account: Profit		150
	£3,450			£3,450

[1] See note (2) on page 997.

Dr. **CASH** Cr.

		£			£
To Bridge, Ltd.		2,550	By Debentures		1,100
			,, Sundry Members		1,450
		£2,550			£2,550

Dr. **SHARES** Cr.

		£			£
To Bridge, Ltd.		2,000	By Sundry Members		2,000

If the debentures plus premium had been formally taken over by Bridge, Ltd., the purchase consideration would have been reduced by £1,100, and the vendor company would have been relieved of its liability accordingly. This would have had the effect of reducing the cash receipt from £2,550 to £1,450 and eliminating the payment to the debenture holders. The Debenture Account of £1,100 would accordingly have been credited to Realization Account. Alternatively, the debit for the premium would not have been made and the original balance of £1,000 been credited to the Realization Account. In both methods the relief to the vending company is £1,000.

The opening Journal entries of the company are—

	(1) Where the Cash is paid to Vendor Company to discharge debt			(2) Where the Liability is formally taken over		
		£	£		£	£
Sundry Assets[1]	Dr.	5,200		Dr.	5,200	
Debtors	Dr.	1,700		Dr.	1,700	
Premium on Debentures (or Goodwill)	Dr.	100		Dr.	100	
To Creditors			2,450			2,450
,, Debenture Holders of Hebden, Ltd.						1,100
,, Hebden, Ltd.			4,550			3,450
Being assets and liabilities taken over and purchase consideration as per agreement dated......						
Debenture Holders of Hebden, Ltd.				Dr	1,100	
Hebden, Ltd.	Dr.	4,550		Dr	3,450	
To Cash			2,550			2,550
,, Share Capital			2,000			2,000
Being discharge of purchase consideration						
		£11,550	£11,550		£11,550	£11,550

[1] Assumed that the purchasing company ignores the bad debts provision of Hebden, Ltd.

[2] Each member of Hebden, Ltd., will receive—

(1) 2 shares in Bridge, Ltd., for 3 held in Hebden, Ltd.

(2) 9s. 8d. in cash for every one share held in Hebden, Ltd., i.e.—

$$\frac{1,450}{3,000} \times 20s. = 9s.\ 8d.$$

Illustration. [*Absorption.*] X, Ltd., agrees to take over Y, Ltd.

The issued share capital of Y, Ltd., is 10,000 shares of £2 each, £1 paid, market value £4 15s.; reserves are £25,000.

X, Ltd., has an issued share capital of 20,000 shares of £3 each, £2 10s. paid, market value £10; reserves are £90,000.

The purchase consideration is the exchange of two shares in X, Ltd. for five in Y, Ltd.; fractions total to 15 shares, which X, Ltd. agrees to pay in cash on market value basis of shares.

Show the closing entries of Y, Ltd., and the opening entries of X, Ltd., in respect of the above acquisition.

The question should occasion no difficulty if it be remembered that share capital and reserves (meaning, by the latter, surplus of undivided profits) must be reflective of assets less liabilities or "net" assets. The details of the latter are not available, so that one must substitute the term "net" assets for assets and liabilities, the amount represented thereby equalling the sum of capital and reserves; thus, if assets are £2,000 and liabilities £400, the "net" assets must be £1,600, which will be reflected in, say, share capital £1,150; reserves, £450.

Hence, it is immaterial in which form the Balance Sheet position is shown, subject to the qualification that if share capital, reserves, and creditors *are* given, the gross assets are the sum of the three, the "net" assets being the latter minus creditors. Thus, in the above, if the figure of £400 liability is disclosed, the balancing figure is gross assets, £2,000.

Closing entries in Ledger form in the books of Y, Ltd., are—

Dr REALIZATION ACCOUNT *Cr.*

		£					£
	To Sundry "Net" Assets .		35,000	By Purchasing Co (X, Ltd)			
	,, Profit on Realization .		5,000	Shares .	£39,850	[1]	
				Cash . .	150	[1]	
							40,000
		£	40,000			£	40,000

Dr. SUNDRY MEMBERS *Cr.*

		£			£
To Shares		39,850	By Share Capital . .		10,000
,, Cash		150	,, Reserves . . .		25,000
			,, Profit on Realization .		5,000
	£	40,000		£	40,000

Opening entries in Journal form in the books of X, Ltd., are—

[1] Posted direct to Sundry Members.

JOURNAL

	£	s.	d.	£	s.	d.
Goodwill . . . . . *Dr.*	5,000	0	0			
Sundry "Net" Assets . . *Dr.*	35,000	0	0			
To Y, Ltd.				40,000	0	0
Being sundry "net" assets and goodwill acquired from Y, Ltd., as per purchase agreement dated						
Y, Ltd. . . . . . . *Dr.*	40,000	0	0			
To Share Capital . . .				9,962	10	0
,, Share Premium[1] . . .				29,887	10	0
,, Bank				150	0	0
Being allotment of 3,985 shares of £3 each, credited as £2 10s. paid, premium thereon, cash paid for fractions; as per directors' resolution dated ......, *vide* Minute Book, p.						

Illustration. [*Absorption.*] The following are the summarized Balance Sheets of X, Ltd., and Y, Ltd.—

BALANCE SHEETS AS AT ....

	X, Ltd.	Y, Ltd.		X, Ltd.	Y, Ltd.
	£	£		£	£
Authorized and Issued Share Capital .	50,000	20,000	Sundry Assets .	45,000	34,000
Profit and Loss Account . . .	3,000		Shares, Y, Ltd. .	20,000	
Creditors . . .	12,000	5,000	Loan, Y, Ltd. .	10,000	
Loan, H, Ltd. . .	10,000		Profit and Loss Account . .		1,000
Loan, X, Ltd. . .		10,000			
£	75,000	£35,000	£	75,000	£35,000

[1] 3,985 shares at [£10 − £2 10s.].

Purchase consideration = 2 shares for every 5, i.e.
= 4,000 shares for 10,000 (the total shares in Y, Ltd.)
= 4,000 × £10 (market price of X, Ltd. Shares)
= £40,000

Discharged in—		£	
Cash for fractions .	15 at £10	150	
Shares . . .	3,985 at £10	39,850	£40,000

Alternatively, goodwill may be debited and Share Premium credited with £7,500, to bring up goodwill to £12,500 to correspond with the market capitalization of the shares computed as follows—

	£
10,000 shares valued at £4 15s. each .	47,500
Represented by "net" assets . .	35,000
Goodwill	£12,500

H, Ltd. (a holding company), owns the whole of the share capital of X, Ltd., the latter owning the whole of the share capital of Y, Ltd.

X and Y (1952), Ltd., is formed to acquire the sundry assets and creditors of X, Ltd. and Y, Ltd., the sundry assets being revalued at £40,000 and £21,000 for X, Ltd. and Y, Ltd. respectively. The amount of loan due to X, Ltd., is to be discharged in shares in the new company, the debt due to H, Ltd., to be similarly discharged. Show the closing Journal entries of X, Ltd., and Y, Ltd. and the opening Journal entries of the new company. Ignore narratives, stamp duties, etc.

X, Ltd. Journal

			£	£
	Profit and Loss Account	Dr.	3,000	
	Share Capital	Dr.	50,000	
	To H. Ltd. [Sole Shareholder] . .			53,000
	Realization Account.	Dr.	45,000	
	To Sundry Assets			45,000
	Creditors	Dr.	12,000	
	To Realization Account . . .			12,000
	X and Y (1952), Ltd.	Dr.	28,000	
	To Realization Account . . .			28,000
	Realization Account.	Dr.	14,000	
	Liquidator, Y, Ltd.[1]	Dr.	6,000	
	To Shares in Y, Ltd.			20,000
	Liquidator, Y, Ltd.[1]	Dr.	10,000	
	To Loan, Y, Ltd			10,000
	Shares in X and Y (1952), Ltd. . .	Dr.	44,000	
	To X and Y (1952), Ltd. . . .			28,000
	,, Liquidator, Y, Ltd.[1]. . . .			16,000
	H. Ltd. [Sole Shareholder] .	Dr	19,000	
	To Realization Account . . .			19,000
	H. Ltd. [Sole Shareholder] . .	Dr.	34,000	
	do. [Loan Account] . . .	Dr.	10,000	
	To Shares in X and Y (1952), Ltd. .			44,000

Y, Ltd., Journal

			£	£
	Share Capital	Dr.	20,000	
	To Profit and Loss Account . . .			1,000
	,, X, Ltd. [Sole Shareholder] . .			19,000
	Realization Account.	Dr.	34,000	
	To Sundry Assets			34,000

[1] See Y, Ltd., Journal—(*contd.* on page 1001)

Y, LTD., JOURNAL (*contd.*)

		£	£
Creditors . . . . . . Dr.		5,000	
To Realization Account . . .			5,000
X and Y (1952), Ltd. . . . Dr.		16,000	
To Realization Account . . .			16,000
X, Ltd. [Sole Shareholder] . . Dr.		13,000	
To Realization Account . . .			13,000
Shares in X and Y (1952), Ltd. . . Dr.		16,000	
To X and Y (1952), Ltd. . . .			16,000
X, Ltd. [Sole Shareholder][1] . . Dr.		6,000	
X, Ltd. [Loan Account][1] . . . Dr.		10,000	
To Shares in X and Y (1952), Ltd .			16,000

The opening Journal entries of X and Y (1952), Ltd., are—

X AND Y (1952), LTD., JOURNAL

		£	£
Sundry Assets (X, Ltd.) . . . . Dr.		40,000	
do. (Y, Ltd.) . . . . Dr		21,000	
To Creditors (X, Ltd.)			12,000
,, do (Y, Ltd.)			5,000
,, Vendor (X, Ltd.)			28,000
,, do. (Y, Ltd.)			16,000
Vendor (X, Ltd.) . . . . . Dr.		28,000	
,, (Y, Ltd.) . . . . . Dr.		16,000	
To Share Capital			44,000

Notes. (1) The liquidator of Y, Ltd., will hand over to the liquidator of X, Ltd. (sole shareholder), the net proceeds of the liquidation; and this must be done before the process of winding up X, Ltd. can be completed.

(2) The reader will find the solution simpler if he writes up the Ledger accounts.

Illustration. X, Ltd., agreed to acquire the business of Y, Ltd. The issued share capital, creditors and debit balance of Profit and Loss Account were, respectively, £30,000 (in £1 shares, 10s. paid), £3,500, and £12,200. The shareholders of Y, Ltd., agreed to take shares in X, Ltd., on the basis of such shares being worth 25s. each, and the shares in Y, Ltd., 7s. 6d. each. (Shares in X Ltd. are £1 fully paid.)

Show opening Journal entries, assuming that X, Ltd., revalues the acquired assets at 90 per cent of the book values appearing in the books of Y, Ltd. Ignore fractions of shares and stamp duties.

[1] See X, LTD., JOURNAL on page 1000

JOURNAL

		£	£
Goodwill . . . . . . *Dr.*		6,830	
Sundry Assets[1] . . . . . *Dr.*		19,170	
To Creditors			3,500
,, Y, Ltd.			22,500
Being business acquired from Y, Ltd. as per purchase agreement dated........			
Y, Ltd. . . . . *Dr.*		22,500	
To Share Capital[2]			18,000
,, Share Premium			4,500
Being allotment of 18,000 shares of £1 each fully paid at 25s. each as per purchase agreement dated........			

Illustration. [*Amalgamation.*] Arundel, Ltd., and Warwick, Ltd., agree upon an amalgamation. Their Balance Sheets are—

BALANCE SHEETS

	Arundel, Ltd.	Warwick, Ltd.		Arundel, Ltd.	Warwick, Ltd.
	£	£		£	£
Authorized and Issued Share Capital of £1 Shares fully paid .	10,000	8,000	Furniture, etc. .	3,000	2,100
Reserve . .		500	Debtors . .	4,800	6,000
Profit and Loss Account . .		1,200	Bank . .	6,120	4,080
Sundry Creditors .	4,300	2,480	Profit and Loss Account .	380	
	£14,300	£12,180		£14,300	£12,180

The assets of Arundel, Ltd., are to be taken at book values, except furniture, which is to be written down by £1,020; those of Warwick, Ltd., are to be taken at book values, except that the

[1] The sundry assets entered into the books of X, Ltd., are—

	£
Share Capital	30,000
Creditors	3,500
	33,500
Less Profit and Loss Account	12,200
Book values of sundry assets in the books of Y, Ltd.	21,300
Less depreciation 10 per cent . . .	2,130
	£19,170

[2] The shares allotted are 18,000, arrived at as follows—

$$60{,}000 \times \frac{7\frac{1}{2}}{25}$$

It will be seen that, ignoring expenses, the shareholders of Y, Ltd. obtain, by the acceptance of shares in X Ltd., the same money equivalent as selling the shares at the current market value, thus—

(*a*) 60,000 shares in Y, Ltd., at 7s. 6d. = £22,500
(*b*) 18,000 shares in X, Ltd., at 25s. = £22,500

It may be deemed desirable to set off the share premium against goodwill.

debtors are to be considered worth £3,300. The share capital of the combined company is to be 8,000 preference shares of £1 each fully paid, and ordinary shares of 10s. each fully paid. The allocation of the shares is equal, except that the surplus capital of Arundel, Ltd. is to be satisfied in preference shares.

Show the Balance Sheet of the new company, and the details of the exchange of shares.

The capital of the new company will be as follows—

	Arundel, Ltd.		Warwick, Ltd.		New Company	
	£	£	£	£	£	£
Assets—						
Furniture, etc. .	1,980		2,100		4,080	
Debtors . .	4,800		6,000		10,800	
Bank . .	6,120		4,080		10,200	
		12,900		12,180		25,080
Liabilities—						
Sundry Creditors . .	4,300		2,480		6,780	
Bad Debts Provision . .	Nil		2,700		2,700	
		4,300		5,180		9,480
Net Capital		£8,600		£7,000		£15,600

This would be satisfied in shares as follows—

	Arundel, Ltd.		Warwick, Ltd.	New Company
	£	£	£	£
Preference Shares of £1 each, fully paid—				
(*a*) For surplus . . .	1,600			
(*b*) Balance equally . .	3,200			
		4,800	3,200	8,000
Ordinary Shares of 10s. each, fully paid		[1]3,800	[1]3,800	7,600
		£8,600	£7,000	£15,600

The exchange of shares is—

ARUNDEL, LTD.—

	4,800 New Company Preference Shares (£1) . 7,600 New Company Ordinary Shares (10s.) .	for	10,000 Shares in Old Company		
i.e.	12 New Company Preference Shares (£1) . 19 New Company Ordinary Shares (10s.) .	for every	25	"	"

WARWICK, LTD.—

	3,200 New Company Preference Shares (£1) . 7,600 New Company Ordinary Shares (10s.) .	for	6,000 Shares in Old Company		
i.e.	16 New Company Preference Shares (£1)[2] . 38 New Company Ordinary Shares (10s.)[3] .	for every	40	"	"

[1] 7,600 *Shares*. [2] Or 2 for 5. [3] Or 19 for 20.

BALANCE SHEET—NEW COMPANY

	£			£
Authorized Capital . .	?	Furniture		4,080
		Debtors . .	£10,800	
Issued Share Capital—		*Less* Bad Debts		
8,000 Preference Shares of £1		Provision .	2,700	
each fully paid . .	8,000			8,100
15,200 Ordinary Shares of		Bank		10,200
10s. each fully paid .	7,600			
Creditors	6,780			
£	22,380		£	22,380

In all probability it will not be possible to divide the shares exactly so that fractional certificates may have to be given. See page 993.

Where companies each holding shares in the other company amalgamate, a statement must be prepared which will be built up on the lines of a Consolidated Balance Sheet prepared in connection with Holding Companies. (See Chapter XXIV.)

Illustration. The following are the abridged Balance Sheets of Further, Ltd. and More, Ltd.—

BALANCE SHEETS

	Further, Ltd.	More Ltd.		Further, Ltd.	More, Ltd
	£	£		£	£
Issued Share Capital	8,000	3,000	Sundry Assets .	11,200	4,000
Profit and Loss Account .	1,500		Goodwill	800	1,000
Creditors	2,500	2,500	Profit and Loss Account		500
	£12,000	£5,500		£12,000	£5,500

Further, Ltd. holds 2,000 shares in More, Ltd. at cost £400, and More, Ltd. holds 1,000 shares in Further, Ltd. at cost £1,400—in each case included in Sundry Assets.

The shares of Further, Ltd. are of £1 and all fully paid; the shares of More, Ltd. are of 10s. and *all are* 6s. *called and paid.* The two companies agree on an amalgamation on the basis that—

(1) A new company is to be formed called Furthermore, Ltd.;

(2) The Goodwill values are (*a*) Further, Ltd. £3,000 and (*b*) More, Ltd. £500;

(3) The shares which each company holds in the other are to be valued at book value having regard to the goodwill valuations in (2);

(4) The new Shares are to be of a nominal value of 5s. and to be credited as 4s. paid.

Prepare (i) new combined Balance Sheet resulting from the merger; (ii) Schedule showing fully the shareholdings therein attributable to the shareholders of Further, Ltd. and More, Ltd.

All costs, etc., are to be ignored.

The position arising out of the above can be best shown in a preliminary summary statement, thus—

	Further, Ltd.	More, Ltd.	Furthermore, Ltd.
	£	£	£
Sundry Assets	11,200	4,000	
Less Shares at cost	400	1,400	
	10,800	2,600	13,400
Goodwill as revised	3,000	500	3,500
Liquidator of—			
More, Ltd.	413		
Further, Ltd.		1,464	
	14,213	4,564	16,900
Deduct Creditors	2,500	2,500	5,000
	11,713	2,064	11,900
Less Due to Liquidators of—			
More, Ltd.—⅛	1,464		
Further, Ltd.—⅕		413	
Due to Shareholders other than Further, Ltd., and More, Ltd.	£10,249	£1,651	£11,900

The computation arriving at the items £413 and £1,464 is as follows—

The Liquidator of Further, Ltd. has "net" assets (excluding the value of the holding in More, Ltd.) of £11,300, i.e. £10,800 + £3,000 less £2,500. To this must be added the value of the holding in More, Ltd. This holding is 2,000 shares. The total *number* of the shares of More, Ltd. is 10,000. The nominal value of 10s. is not material in arriving at this figure; the criterion is the *paid up* value of 6s. Hence, the item of £3,000 representing the share capital of More, Ltd. in full detail is 10,000 shares of 10s. each, 6s. called and paid equals £3,000.

Arising from these facts it is clear that Further, Ltd. owns one-fifth of the equity of More, Ltd., as it holds 2,000 shares out of the 10,000, so that whatever may be the value of the equity of More, Ltd., Further, Ltd. gets one-fifth; but the value of such equity cannot be determined until the value of the equity of Further, Ltd. is known as More, Ltd. has, through its shareholding in Further, Ltd., an interest therein. Such interest is one-eighth as More, Ltd. owns 1,000 shares of £1 each fully paid (out of 8,000) of Further, Ltd.

Consequently it is seen that Further, Ltd. owns *one-fifth* of More, Ltd. and the latter owns one-eighth of Further, Ltd.

The position of the liquidator of each company can now be clarified and it is immaterial which company is taken first.

As the position of the Liquidator of Further, Ltd has already been mentioned, this company will be used as the basis of the required computation.

The Liquidator has already £11,300 of net assets to which must be added the value of the holding in More, Ltd This is one-fifth of the equity of the latter company. Hence the total is £11,300 + $\frac{1}{5}$M (letting M symbolize the equity of More, Ltd). But what is the worth of M? It is £600 (excluding its proportion of Further, Ltd, i e £2,600 + £500 — £2,500) plus the value of the holding in Further, Ltd. As its holding in Further, Ltd is one-eighth, M s total is £600 plus $\frac{1}{8}$F (letting F symbolize the equity of Further, Ltd).

$$
\begin{aligned}
\text{Thus} \qquad F &= 11{,}300 + \tfrac{1}{5}M \text{ and } M = 600 + \tfrac{1}{8}F. \\
\therefore \quad F &= 11{,}300 + \tfrac{1}{5}(600 + \tfrac{1}{8}F) \\
&= 11{,}300 + 120 + \tfrac{1}{40}F \\
&= 11{,}420 + \tfrac{1}{40}F \\
\therefore \quad 40\,F &= 456{,}800 + F \\
\therefore \quad 39\,F &= 456{,}800 \\
\therefore \quad F &= 11{,}713 \text{ to nearest £.}
\end{aligned}
$$

Therefore the value of F's holding in M is £11,713 less £11,300 = £413.

The liquidator of Further, Ltd. will bring into account £413, thus bringing the equity of that company to £11,713, but as More, Ltd owns one-eighth thereof, £1,464 is attributable to the latter company

The liquidator of More, Ltd will bring into account the aforesaid £1,464, thus bringing the equity of that Company to £2,064 [£600 "other" net assets plus £1,464], but as Further, Ltd owns one-fifth thereof, £413 is attributable to the latter company.

[The item of £1,464 can be proved by proceeding to work out the value of M, thus—

$$M = 600 + \tfrac{1}{8}F, \text{ but } F = 11{,}300 + \tfrac{1}{5}M$$

Substituting for F (11,300 + $\frac{1}{5}$ M)

$$
\begin{aligned}
M &= 600 + \tfrac{1}{8}(11{,}300 + \tfrac{1}{5}M) \\
\therefore \quad 8\,M &= 4{,}800 + 11{,}300 + \tfrac{1}{5}M \\
&= 16{,}100 + \tfrac{1}{5}M \\
\therefore \quad 40\,M &= 80{,}500 + M \\
39\,M &= 80{,}500 \\
M &= 2{,}064 \text{ to nearest £}
\end{aligned}
$$

Therefore the value of M's holding in F is £2,064 less £600 = £1,464]

The basis of exchange is (after cancelling the inter-company shareholdings)—

	Original Shares	*Cancelled Shares*	*Balance of General Shareholders*	*New Company Equity for General Shareholders* £	*Shares of 5s Each 4s Paid*
Further, Ltd	8 000	*less* 1 000 (owned by More Ltd)	7 000	10,249	51 245
More, Ltd	10,000	*less* 2,000 (owned by Further, Ltd)	8,000	1,651	8,255
				£11 900	59,500

The general shareholders of Further, Ltd. will receive for their 7,000 shares of £1 each fully paid, 51,245 shares of 5s. each, 4s. paid, in Furthermore, Ltd.; and the general shareholders of More, Ltd. for their 8,000 shares of 10s. each 6s. paid, 8,255 shares of 5s. each, 4s. paid. Provision would obviously have to be made for fractions (exactly how many will depend upon the composition of the shareholding) but approximately in the case of Further, Ltd. the share exchange would be 7 new for 1 old, absorbing 49,000, leaving 2,245 to be dealt with by means of fractions; and in the case of More, Ltd. the share exchange would be 1 new for 1 old leaving 255 to be dealt with by means of fractions.

The abridged Balance Sheet resultant on the amalgamation will be—

FURTHERMORE, LTD.

	£		£
Issued Share Capital—		Sundry Assets . . .	13,400
59,500 Shares of 5s. each,		Goodwill	3,500
4s. paid . . .	11,900		
Creditors. . . .	5,000		
	£16,900		£16,900

If the fractions are to be dealt with by payment of the cash equivalent 4s. [not 5s.], the liabilities side would be modified accordingly; the undermentioned details taking the place of Share Capital £11,900—

	Shares of 5s. (4s. paid) to be Allotted		*Cash Payable*	£
		£		
To Further, Ltd..	49,000 =	9,800	2,245 Shares at 4s. . .	449
More, Ltd. .	8,000 =	1,600	255 Shares at 4s. . .	51
	57,000 =	£11,400	2,500	£500

The abridged Balance Sheet will then be—

FURTHERMORE, LTD.

		£		£
Issued Share Capital—			Sundry Assets . . .	13,400
57,000 Shares of 5s. each,			Goodwill . . .	3,500
4s. paid . . .		11,400		
Amalgamation Creditors—				
Liquidator				
Further, Ltd. .	£449			
More, Ltd. . .	51			
		500		
Creditors		5,000		
		£16,900		£16,900

Illustration. X Bank, Ltd., with a called-up capital of £300,000 in £20 shares, £1 paid, market value £25, and a reserve fund of £1,750,000, purchases on 30th November, for £14 a share (payable

as to one-half in shares, market value £25, and the other half in 5% Debentures at par), the business of Y Bank, Ltd. The share capital of the latter was £200,000 in £15 shares, £4 paid, market value £12 10s., and a reserve fund of £350,000.

On 31st January next a dividend of 6s. a share was paid for the half-year to date.

Show Balance Sheet after completion of the above purchase ignoring duties and tax.

X Bank, Ltd

Balance Sheet (*after* completion)

	£		£
Issued Share Capital	314,000	Goodwill . . .	152,800
Premium on Shares .	336,000	Net Assets, *less* provision	
5% Debentures . .	350,000	for Dividend . .	2,597,200
Reserve Fund . .	1,750,000		
	£2,750,000		£2,750,000

The net assets taken over from Y, Ltd., are £547,200, being the net assets comprised in the Issued Share Capital £200,000 and Reserve Fund £350,000, less dividend of 4s. a share (the proportion of the 6s. dividend accruing at the date of sale, on 50,000 shares.) This dividend amounts to [1]£2,800, leaving £547,200 as stated above. The purchase price is 50,000 shares at £14 equals £700,000. As the purchase price amounts to £700,000, the Goodwill is £152,800. The foregoing purchase price is discharged as follows: (*a*) issue of 14,000 shares in X, Ltd., worth £25 each to discharge half the purchase price, viz. £350,000, but as the shares of X, Ltd., are £1 paid only, the Share Capital Account will be credited with £14,000 and Premium on Shares with £336,000; (*b*) issue of 5% Debentures amounting to £350,000.

The position may now be shown as follows—

	Debits		Credits	
		£		£
Goodwill: Y Bank, Ltd. .		*152,800*		
Net Assets: X Bank, Ltd. .	£2,050,000			
Y Bank, Ltd .	*547,200*	2,597,200		
Share Capital Issued . .			£300,000	
Share Capital Issued . .			*14,000*	314,000
Premium on Shares . .				*336,000*
5% Debentures . . .				*350,000*
Reserve Fund . . .				1,750,000
		£2,750,000		£2,750,000

The entries in italics represent in abridged form the opening Journal entries in respect of the acquisition of Y Bank, Ltd.

[1] 4s. a share on 14,000 shares allotted to the members of Y, Ltd.

Relief from Capital and Transfer Stamp Duty. In case of reconstruction or amalgamation of companies, Sect. 55, Finance Act, 1927, as amended by Sect. 31, Finance Act, 1928, Sect. 36, Finance Act, 1930, and Sect. 41, Finance Act, 1933, provides relief as follows—

If in connection with any reconstruction or amalgamation, on the acquiring company taking over the undertaking of, or not less than 90 per cent of, the issued share capital of another company,[1] the consideration for the purchase (excluding the taking over of liabilities) is discharged in the form of shares, the nominal share capital in the case of a new company, or the increase in the case of one already in existence, shall be treated as *reduced* by—

(*a*) An amount equal to the share capital of the vending or subsidiary company; or

(*b*) Where only *part* of the undertaking of the vending company is acquired, by that proportion of the share capital of the vending company which the portion of the undertaking acquired bears to the whole undertaking; or

(*c*) If the shares issued as consideration are credited as *partly* paid up, only the amount credited as paid up is available for relief, if this is less than the amount computed in (*a*) and (*b*).

Certain causes will cancel the relief (e.g. fraud), and where the company ceases to be the beneficial owner of the shares acquired.

In the above circumstances, subject to certain conditions, no conveyance or transfer duty is chargeable on any instrument in connection with the transfer of the undertaking or shares, or with the assignment of liabilities to be taken over by the acquiring company.

In order to obtain the benefit of the exemption from capital duty, the instrument must be executed within twelve months of the registration of the company where the acquiring company is a new company, or of the increase in share capital where it is an existing one.

To obtain the benefit of these reliefs, if the undertaking is taken over, then it is immaterial whether the shares given in exchange are allotted to the existing company or to its shareholders; but if the undertaking is not taken over but *shares* acquired therein, then the allotment of the shares exchanged must be to the *holders* of the shares in the existing company. If the allotment is to the existing *undertaking* itself no relief is available (*Murex* v. *C. I. R.*).

Illustration. X, Ltd., is formed to take over the undertaking of Y, Ltd., and upon registration the former company pays capital duty on £20,000. The nominal share capital of Y, Ltd., is £15,000 in £1 shares.

Assuming that the purchase consideration wholly discharged in fully paid shares is (*a*) £18,000, (*b*) £12,000, show relief in respect of capital duty available to X, Ltd.

[1] The company whose shares are acquired must have been incorporated in this country (see *The Nestlé Company, Ltd* v. *C.I.R.*, when exemption was refused in respect of companies incorporated in Northern Ireland).

(*a*) The *relief* is 10s. per cent of £15,000.
(*b*) The *relief* is 10s. per cent of £12,000.

If X, Ltd., had already existed, the relief in respect of the increase of share capital needed to acquire Y, Ltd., would be as above.

If X, Ltd., had similarly acquired from members of Y, Ltd., 90 per cent[1] of their shares (Y, Ltd., remaining in existence), the relief would be (*a*) £13,500 [i.e. 90 per cent of £15,000]; (*b*) £12,000.

The above relief is subject to the conditions already outlined.

Illustration. Z, Ltd., has a Nominal Capital of £20,000, half of which is issued and fully paid. For the purpose of acquiring 95 per cent[1] of the undertaking of R, Ltd. (Nominal Capital, £27,000), Z, Ltd., increased its Nominal Capital by £15,000. The purchase consideration is £20,000 payable in 16,000 £1 shares credited as 15s. paid and £8,000 in cash.

Show the Stamp Duty payable on the increase of capital.

	£
For the purpose of 10s. per cent Stamp Duty, the increase in the nominal capital of Z, Ltd., of . .	15,000
is reduced by	
(*a*) 95 per cent of the nominal capital of R, Ltd., £25,650; or	
(*b*) The amount credited as partly paid on 16,000 shares 15s. paid, issued as purchase consideration, i.e. £12,000, whichever is *less*	12,000
∴ 10s. per cent Stamp Duty is payable on . .	£3,000

Illustration. [*Internal Reconstruction.*] The Balance Sheet of Dunster, Ltd., at 31st December, 19.., is as follows—

BALANCE SHEET AS AT 31ST DECEMBER, 19..

		£		£
Authorized and Issued Share Capital: 80,000 Shares of £1 each fully paid . .		80,000	Sundry Assets . . .	154,000
Debentures . .	£134,000		Investments . . .	3,000
Plus Interest (net)	4,000		Profit and Loss Account .	107,000
		138,000		
Creditors—				
Income Tax . .	£1,000			
General . . .	45,000			
		46,000		
		£264,000		£264,000

The following reconstruction is passed and duly sanctioned—

(1) Each share is to be subdivided into twenty fully-paid ordinary shares of 1s. each.

(2) After such subdivision, each shareholder shall surrender to the company 95 per cent of his holding, for the purpose of reissue

[1] See Sect. 209, Companies Act, 1948, re power to acquire shares of dissenting minority when scheme approved by shareholders of not less than 90 per cent in value.

to debenture-holders and creditors, so far as is necessary, and the balance cancelled.

(3) Of those surrendered, 460,000 shares of 1s. each shall be converted into participating preference shares of 1s. each fully paid.

(4) The claims of the debenture-holders shall be reduced by 16s. 8d. in the £; in consideration therefor the debenture-holders shall *also* receive participating preference shares to the value of 3s. 4d. in the £ upon their claims as at 31st December, 19...

(5) The income tax liability is to be paid in full; and the claims of the other creditors be reduced to 4s. in the £, to be satisfied by the issue of ordinary shares of 1s. each *ex* the shares surrendered.

(6) The shares surrendered and not reissued to be cancelled.

Set out Journal entries and resultant Balance Sheet, assuming that the tax liability is still outstanding and that the amounts of the assets are unaltered. The merits of the scheme may be ignored.

It is advisable in a question of this nature to construct a rough tabular statement and therefrom compile the revised Balance Sheet; then proceed to the Journal entries. (See below.)

(1) The members lose 95 per cent of their capital, viz. £76,000, leaving them with £4,000 in shares.

(2) The debenture holders lose 13s. 4d. in the £, because they receive back in another form 3s. 4d. out of their 16s. 8d. loss, thus $\frac{2}{3}$ × £138,000 = £92,000 is a gain to the company, leaving the debenture holders with $\frac{1}{3}$ × £138,000, viz. £46,000, in—

	£
Preference Shares	23,000
Debentures	23,000
	£46,000

(3) The creditors lose $\frac{4}{5}$ × £45,000, that is, a gain to the company of £36,000, the creditors being allotted £9,000 of ordinary shares. There is thus a total gain to the company of £204,000, which is utilized in eliminating the adverse balance of profit and loss of £107,000, leaving a reserve of £97,000.

Old Balance Sheet Items	Total	Creditors	New Ordinary Shares	Participating Preference Shares	Debentures	Profit
	£	£	£	£	£	£
Share Capital	80,000		4,000			76,000
Debentures	138,000			23,000	23,000	92,000
Creditors	45,000		9,000			36,000
Income Tax	1,000	1,000				
Total . .	264,000	1,000	13,000	23,000	23,000	204,000
Elimination of Profit and Loss Account .	107,000					
Reserve . . .	97,000					204,000

The resultant Balance Sheet will be—

DUNSTER, LTD.,[1] BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£		£
Authorized and Issued Share Capital— 80,000 Ordinary Shares of £1 each fully paid reduced (as sanctioned by the Court) to— 260,000 Ordinary Shares of 1s. each fully paid .	13,000[3]	Sundry Assets . . .	154,000[2]
460,000 Participating Preference Shares of 1s. each fully paid . .	23,000[3]	Investments . . .	3,000[2]
Reserve	97,000[3]		
Debentures . . .	23,000[3]		
Income Tax . . .	1,000[3]		
£	157,000	£	157,000

It will be of material assistance if the student prepares rough Ledger Accounts, because many of the entries in the Journal deal with balances of accounts.

JOURNAL

		£	£
	Share Capital (Old) . . . . *Dr.*	80,000	
	To Ordinary Share Capital .		80,000
	Being subdivision of 80,000 shares of £1 each fully paid into 1,600,000 shares of 1s. each fully paid pursuant to scheme passed by special resolution dated ...., confirmed by Court Order dated ...., *vide* Minute Book, p.		
	Ordinary Share Capital . . *Dr.*	76,000	
	To Surrendered Shares. . .		76,000
	Being surrender of 95% of ordinary shares, viz. 1,520,000 to be dealt with in accordance with scheme.		
	Debentures . . . . . *Dr.*	111,000	
	Interest on Debentures . . *Dr.*	4,000	
	General Creditors . . . *Dr.*	45,000	
	To Reconstruction Account . .		160,000
	Being reduction of 16s. 8d. in £ on the rights of debenture-holders and surrender of the rights of unsecured creditors.		

[1] (And reduced) if the Court orders.
[2] Per original Balance Sheet.
[3] From the statement on page 1011, accounting for the remaining figures in the original Balance Sheet.

JOURNAL—(*contd.*)

		£	£
	Surrendered Shares . . . *Dr.*	76,000	
	To Participating Preference Share Capital		23,000
	,, Ordinary Share Capital . .		9,000
	,, Reconstruction Account . .		44,000
	Being issue of 460,000 participating preference shares of 1s each fully paid (into which 460,000 of the surrendered shares have been converted) and 180,000 ordinary shares of 1s. each fully paid (4s. in £), and cancellation of shares surrendered and not reissued as per scheme.		
	Reconstruction Account . . *Dr.*	204,000	
	To Profit and Loss Account . .		107,000
	,, Reserve		97,000
	Being cancellation of profit and loss balance and creation of reserve in pursuance of reconstruction scheme		

Illustration. [*Internal Reconstruction.*] The following is the Balance Sheet of S. M., Ltd.—

BALANCE SHEET AS AT 1ST JANUARY, 19..

		£			£
Authorized and Issued Capital:			Sundry Assets . . .		15,000
20,000 Ordinary Shares of £1 fully paid . . .		20,000	Investment on Workmen's Compensation Fund .		3,000
18,000 7% Preference Shares of £1 fully paid . .		18,000	Property:		
"A" 6% Debentures (secured on London Property) . .		3,000	London . .	£16,000	
"B" 6% Debentures (secured on Manchester Property) .		3,500	Manchester .	12,000	
Workmen's Compensation Fund:					28,000
London .	£2,000		Profit and Loss Account .		4,000
Manchester	1,000				
		3,000			
Creditors		2,500			
	£	50,000		£	50,000

A scheme was duly prepared and sanctioned, whereby—

(*a*) Ordinary shares were to be reduced to 2s.

(*b*) Preference shares were to be reduced to 16s.

(*c*) Debenture-holders forgo their interest (£520), which is included among sundry creditors.

(*d*) "B" debenture-holders agreed to take over the Manchester property at £5,000; to accept an allotment of 3,000 2s. ordinary shares at par; and upon their forming a company called M. P., Ltd.

to take over the Manchester property, they allotted S. M., Ltd., 1,800 £1 shares fully paid at par.

(*e*) The Manchester Workmen's Compensation Fund disclosed the fact that there were liabilities of £200. In consequence, the investments and the fund were realized to the extent of the balance, the investment realizing a profit of 10 per cent on book value, and the proceeds used for part payment of the creditors.

(*f*) The sundry assets were to be written down by £9,000, any balance to be applied as to three-quarters in writing down the London property, one-quarter to a capital reserve.

Show Journal entries covering these steps.

JOURNAL

	£	£
Ordinary Share Capital . . . . *Dr.*	18,000	
7% Preference Share Capital . . *Dr.*	3,600	
Sundry Creditors (Debenture Interest) *Dr.*	520	
Workmen's Compensation Fund (Manchester) . . . . . *Dr.*	880	
To Capital Reduction Account . .		23,000
Being reduction of capital, viz. 20,000 ordinary shares of £1 each to 2s. each; 7% preference shares of £1 each to 16s. each; cancellation of debenture interest; and elimination of proportion of workmen's compensation fund in pursuance of scheme of reduction as per special resolution ...., confirmed by Court Order dated ......, *vide* Minute Book, p.		
Capital Reduction Account . . . *Dr.*	23,000	
To Manchester Property		7,000
,, Sundry Assets		9,000
,, Profit and Loss Account . . .		4,000
,, London Property		2,250
,, Capital Reserve		750
Being assets written down in pursuance of scheme of reduction.		
"B" Debenture-holders . . . . *Dr.*	5,000	
To Manchester Property		5,000
Being transfer of Manchester Property at valuation in pursuance of scheme of reduction.		
"B" Debenture-holders . . . . *Dr.*	300	
To Ordinary Share Capital		300
Being allotment of ordinary shares in part settlement of liability to debenture-holders.		
"B" Debentures . . . . . . *Dr.*	3,500	
Investment (Shares in M.P., Ltd.) . *Dr.*	1,800	
To "B" Debenture-holders . . .		5,300
Being discharge of balance by investments and transfer from "B" Debentures Account.		

JOURNAL—(*contd.*)

			£	£
	Cash . . . . *Dr.*		880	
	To Workmen's Compensation Investment, Manchester . . .			800
	,, Workmen's Compensation Fund, Manchester			80
	Being amount received from workmen's compensation fund investments and transfer of profit thereon to fund.			
	Creditors . . . . . . *Dr.*		880	
	To Cash			880
	Being part payment of liability to creditors.			

DRAFT BALANCE SHEET AS AT 1ST JANUARY, 19..

	£	£		£	£
Authorized Share Capital—			Sundry Assets . . .	15,000	
Ordinary Shares—200,000 of 2s. each		20,000	*Less* written off by Order of Court	9,000	
7% Preference Shares—22,500 of 16s. each		18,000			6,000
	£	38,000	Investments on Workmen's Compensation Funds—		
			London	2,000	
			Manchester . . .	200	
Issued Share Capital—					2,200
Ordinary Shares—23,000 of 2s. each fully paid . . .		2,300	Shares in M.P., Ltd., at Cost .		1,800
7% Preference Shares—18,000 of 16s. each fully paid . .		14,400	London Property . . .	16,000	
Capital Reserve		750	*Less* written off by Order of Court	2,250	
"A" 6% Debentures (secured on London Property) . . .		3,000			13,750
Workmen's Compensation Funds—					
London	2,000				
Manchester	200				
		2,200			
Creditors		1,100			
	£	23 750		£	23,750

It will usually be advisable to prepare rough "working" accounts for the more difficult and involved entries, thus—

Rough Accounts—

W.C.F. INVESTMENTS (M/c)

	£		£
To Balance .	1,000	By Sale . .	800
		,, Balance .	200
To Balance[1] .	200		

"B" DEBENTURE-HOLDERS

	£		£
To M/c Property	5,000	By "B" Debentures .	3,500
,, Ordy. Share Capital .	300	,, Investment A/c . .	1,800

W.C. FUND

	£		£
To Capital Reduction .	880	By Balance .	1,000
,, Balance .	200	,, Profit . .	80
		By Balance[1] .	200

CREDITORS

	£		£
To Capital Reduction .	520	By Balance	2,500
,, Cash . .	880		
,, Balance .	1,100		
		By Balance	1,100

[1] The balances may be transferred to General Investments and Liabilities respectively

The form in which the reconstruction is to be carried out involves a consideration of variable premises, most of which are omitted from examination questions. It is therefore essential that, in addition to the submission of the formal answer in the light of the circumstances and facts disclosed, suitable comments should be made.

Principles underlying Reconstruction.

(1) The scheme should be clear cut, easily understood by laymen and non-controversial.

(2) No attempt should be made to put through an unjust and unfair scheme.

(3) The scheme should avoid the setting off of one class of members against another.

(4) Whatever proposals are made, the essence of them is the earning power of the company. All members, even debenture-holders, are dependent for their income on the company's earnings.

(5) Latest figures of actual earnings should be given, supplemented by careful and honest estimates of future earning power.

(6) No class of members should be called upon to make sacrifices for the benefit of another class except where absolute necessity dictates, e.g. if there is no prospect within a reasonable time of paying dividends to ordinary shareholders except at the expense of the Preference Shareholders, the latter should not generally be called upon to sacrifice their Capital and/or Income. The ordinary shareholder is assumed to know the risk attaching to his holding. On the other hand if, taking a long term view, the position is such that there is little prospect of the Preference Shareholder receiving dividends, then some adjustment will be called for, particularly as the ordinary shareholder should not be called upon to renounce for all time his prospect of receiving dividends.

(7) Regard must be had to real as distinct from apparent sacrifices, and a cut in the Capitals of both Preference and Ordinary Shares would give the latter an advantage over the former unless the Preference Shareholders were compensated.

(8) No change should take place in the respective positions except where unavoidable, e.g. generally speaking a preference shareholder will want to remain as such and not become an ordinary shareholder, and conversely, so that—

(9) Contractual rights and priorities should be maintained as far as possible.

The matters likely to call for practical attention in problems of this nature are—

(1) Whether the reconstruction should be "internal" or "external."

(2) Whether the company's affairs have reached stability, so that another reconstruction in the future may be avoided.

(3) The respective rights of the various classes of members as to—

(*a*) Capital repayment in a winding up.
(*b*) Dividends.
(*c*) VOTING powers.

(4) A careful consideration of the proposed alterations in so far as they are likely to affect the rights of *members*, having regard to the possibility of a refusal by a class to acquiesce.

(5) Where the reconstruction involves some sacrifice on the part of *creditors*, including debenture-holders, the proposals which are likely to meet with their approval must be carefully considered; whether, for instance, they will be likely to agree to a composition for cash, or for cash and shares, or for shares only.

(6) In all cases, especially where the immediate trouble is the shortage of working capital, the question of raising the additional capital will require consideration.

(7) Involved in the scheme may be the reorganization of the business and technical side of the company, together with a possible reconstitution of the size and personnel of the Board of Directors. The desirability of the appointment of a new chairman may call for consideration.

(8) In order to ascertain the amount to be written off against members (and possibly creditors), the assets and liabilities will be revalued, so that the company can start with a "clean slate." This obviously will necessitate not only the revision of book values of assets and liabilities, but the complete elimination of such debit balances as are not in the nature of assets, examples of which are preliminary expenses and profit and loss debit balance.

Accounting Aspect of Reconstructions. The chief matters that directly concern accounting work are those relating to the reconstitution of the share capital, and the revision of the values of the assets and liabilities. After the advice of the accountant has been sought as to the opportuneness and method of reconstruction, having regard to all the circumstances, assets (the valuation of which may require the services of technical experts) will be adjusted accordingly. When the revised capital balance has been struck, the task of the accountant is to evolve an *effective* scheme which is fair and just as between all parties. The particular aspects, at all events for examination purposes, which will require careful consideration are—

(1) The position of each class of member as regards potential dividends.

(2) The position of each class of member in the event of liquidation.

(3) The treatment of "arrears" (if any) on cumulative preference shares.

(4) The position of (1) debenture-holders, having regard to the nature and value of their security, and (2) creditors.

(5) The particular assets and liabilities chosen to be adjusted.[1]

(6) The practical point of allotting a reasonably large number of shares (even if of low denomination), and the exchange basis such as to avoid so far as is possible the use of share fractions.

(7) The gearing of the reconstituted Share Capital.

(8) The resultant voting power.

Speaking generally, unless the earning capacity of the company has become permanently impaired, it is neither just nor reasonable that the preference shareholders should suffer a reduction in the amounts receivable in dividends. The preference shareholder has taken shares of this class upon the understanding that he should have a prior right to dividend over that possessed by the ordinary shareholder, but without right to further participation in the profits. In order to keep faith it is the duty of the company to preserve this right as far as possible. It must be borne in mind, however, that usually the control of the company lies with the ordinary shareholders, who would have the power to withhold dividends from the preference shareholders until the adverse balance of profit and loss had been made good out of future profits. As a result, the preference shareholders are generally quite willing to accept a curtailment of some rights in return for the prospect of dividend being paid to them in the very near future.

Another matter which will tend to create an accommodating spirit amongst the preference shareholders is the fact that often the only alternative to the reconstruction is liquidation. The latter will usually involve losses owing to forced sale, such losses being borne entirely by the preference shareholders if the position is so serious that the capital of the ordinary shareholders is already lost.

The important point from the dividend aspect is that so far as the ordinary shareholders are concerned (assuming two classes only, viz. preference and ordinary), it is quite immaterial at what book value the shares appear in the books of the company, as the true value depends upon the annuity value or yield basis, so that if, after reconstruction, they are still entitled to all the SURPLUS profits, or the same proportion as before, their dividend position is unimpaired.

The position of the ordinary shareholders is unaffected as regards dividends if—

(1) There is no alteration in *amount*, *rate*, or *priority* of the preference shares.

(2) No other class of shareholders is admitted into the participation of the "equity" of the ordinary shareholders, or if such right already exists, it remains unchanged.

Any diminution of the foregoing rights will benefit the ordinary shareholders.

[1] If Plant is written down, it will lighten the burden of the depreciation charge until such time as the Plant requires replacement, whilst a reduction of an interest bearing liability will lighten the burden of the interest charge.

A share will be just as valuable if it obtains an annual dividend of, say, 1s., whether it is denominated and credited in the company's books at £10 or £1 or 5s., or even 1d., inasmuch it provides the SAME annuity in each case.

Where debenture-holders suffer a reduction in the amount of interest they receive from the company, whether in rate or book value of the debentures, the burden on the company will be correspondingly reduced, thus benefiting its members.

Illustration. The issued share capital of Eldwick, Ltd., is 10,000 6 per cent Preference Shares and 20,000 Ordinary Shares all of £1 each, fully paid. The net assets are £13,000, and the debit balance of Profit and Loss Account is £17,000.

Assuming that the company has "turned the corner" and ignoring other considerations, e.g. liquid position of the company, it is obvious that it is to the advantage of the company as a whole to reconstruct by a thorough revaluation and, as a necessary concomitant, the reorganization of the capital, so as to enable the company to resume payment of dividends at an early date.

If the net assets are, upon revaluation, considered to be worth £11,000 only, this involves a capital loss of £19,000, made up as follows—

	£
(i) Reduced Value of Assets . .	2,000
(ii) Elimination of Fictitious Asset . .	17,000
	£19,000

If it is agreed to charge this up to the ordinary shareholders, leaving them with £1,000 of capital instead of £20,000, it is immaterial whether that capital is in the form of 1,000 shares of £1 each fully paid, or 20,000 shares of 1s. each fully paid, for their "equity" will remain unaltered. The preference shareholders appear to be sufferers in one sense, as the capital security is diminished as compared with the position when there was no debit balance on Profit and Loss Account, yet the mere formality of bringing down the position to "rock bottom" makes the real security neither worse nor better than immediately before the reconstruction. The damage was done during the period prior to the inauguration of the scheme. Actually their comparative position in a winding up *vis-à-vis* the ordinary shareholder may be strengthened. From a dividend point of view, their position is that they are still entitled to their annual dividend of 6 per cent on their *unaltered* share capital before the ordinary shareholders can possibly participate in the profits.

As regards the ordinary shareholders, the priorities ranking in front of them are still the same, hence their share in the surplus of the divisible profits is not jeopardized by the writing down of £20,000 to £1,000.

If the company in the year after reconstruction earns (and distributes) £1,100, the preference shareholders will receive £600, leaving £500 for the ordinary shareholders. This will be distributed as follows—

	£
(a) Assuming that no reconstruction took place—$2\frac{1}{2}$% on 20,000 £1 shares	500
(b) Assuming the reconstruction resulted in the Ordinary Shares being written down to—	
(1) 20,000 shares of 1s. each—6d. a share, or 50% on 20,000 1s. shares	500
(2) 1,000 shares of £1 each—10s. a share, or 50% on 1,000 £1 shares	500

Assuming, further, that $7\frac{1}{2}$ per cent yield would be required on an ordinary share of this class, the valuations are—

		£	s.	d.
(a)	$\frac{2\frac{1}{2}}{7\frac{1}{2}} \times$ £1 = 6s. 8d. on 20,000 £1 shares . .	6,666	13	4
(b) (1)	$\frac{50}{7\frac{1}{2}} \times$ 1s. = 6s. 8d. on 20,000 1s. shares . .	6,666	13	4
(2)	$\frac{50}{7\frac{1}{2}} \times$ £1 = £6 13s. 4d. on 1,000 £1 shares .	6,666	13	4

If the "arrears" of cumulative preference dividends are to be brought into account in the reconstruction, the position of the ordinary shareholders is generally adversely affected (assuming that they are not compensated in other directions), because—

(1) If the "arrears" of cumulative preference dividends are converted into preference shares, more of the profits will be "charged" to meet the dividend on the increased number of preference shares; but against this the RATE per cent payable on the preference shares may be reduced, the consequences of which will be to offset, wholly or in part, the increased "charge."

(2) If such "arrears" are converted into ordinary shares, it results in the proportion of surplus profits, payable to ordinary shareholders, being reduced in consequence of the increased number of participants, but this will hasten the time when the ordinary shareholders will receive dividends because the "arrears" of preference dividends are no longer in the way.

(3) If the "arrears" are converted into Income Certificates there will be an increased charge not only for interest, but for providing a Sinking Fund for their redemption. The latter however becomes "free" when the certificates have been redeemed.

Briefly, the ordinary shareholders benefit to the extent of obtaining an early participation in dividends, but sacrifice some proportion thereof by having them curtailed to the extent required to pay dividends on the shares issued to the preference shareholders in cancellation of the "arrears" of their dividends.

Before proceeding further, it is important to note that in the majority of reconstructions, only part of the "arrears" are given in shares, the preference shareholders sacrificing the remainder.

Illustration. Taking the facts as in the previous illustration, the arrears on the 6 per cent preference shares (assumed to be cumulative) are, say, £2,400, that is, no dividends have been paid on these shares for four years, and the capital is reorganized by debiting the

whole of the capital loss to the ordinary shareholders by reducing the nominal value to 1s. The "arrears" are to be cancelled, and in lieu thereof the preference shareholders are to be allotted four new ordinary shares of 1s. each for five preference shares.

Ignoring the treatment of "arrears," the revised position would be—

	£
10,000 6% Preference Shares of £1 fully paid .	10,000
20,000 Ordinary Shares of 1s. each fully paid .	1,000
	£11,000

This figure is represented by Net Assets at their revised value—£11,000, as against £13,000 previously.

As there are to be created further ordinary shares to the extent of 8,000 of 1s. each ($\frac{4}{5}$ of 10,000) and no book liability exists for the "arrears" (not being a real liability), the issue will involve either an increase (by writing up the assets) or a diminution of the ordinary share capital. If the ordinary shareholders are to surrender the required amount to cover the £400, they will suffer by having less "equity" in the surplus, as they retain £600 only of their £1,000. On the other hand, the matter may be adjusted by reference to the assets, the latter being reduced not by £2,000 as mentioned, but by £1,600 only. This will leave the ordinary capital at £1,400 (£1,000 for the ordinary shareholders and £400 for the preference shareholders in respect of the "arrears" of dividends). In the first case, the surplus profit available for the old ordinary shareholders is $\frac{6}{10}$, whereas in the second it is $\frac{10}{14}$ or $\frac{5}{7}$, the detrimental effect of the former as compared with the latter being $\frac{4}{35}$ (the difference between $\frac{5}{7}$ and $\frac{6}{10}$) of the surplus profits.

The usual practice is to obtain an approximate valuation of tangible assets; to ascertain the effect on share capital; and, if necessary, to effect an equitable readjustment of capital by an adjustment of the valuation of goodwill. The viewpoint of winding up must be briefly considered, and this will be dealt with on pages 1023 *et seq.*

Other arrangements may be entered into with reference to the arrears, e.g. £400 may be allotted in preference shares, or split between the preference shares and ordinaries, or an entirely new class of share created, say, preferred ordinary ranking for dividends after the preference, but before the ordinary shares. To deal with each possible arrangement is impossible in a work of this description, but the principles involved are the same, viz. (1) what amount of profit will be required to meet the dividend of the prior classes of shares; and (2) what amount (not merely rate) of dividend will be available to the lower grade shares.

The position may be compared by taking three alternatives—

(*a*) Where the "arrears" are given to the preference shares in *preference* shares.

(*b*) As in (*a*), except that *ordinary* shares are allotted.

(*c*) Where the "arrears" are split into equal parts of preference

and ordinary, the increase of £400 being borne by the present holders of ordinary shares.

The Balance Sheets will be thus—

	(a) £	(b) £	(c) £		(a)[1] £	(b)[1] £	(c)[2] £
Preference Shares—				Net Assets .	11,400	11,400	11,000
Old . .	10,000	10,000	10,000				
New .	*400*		*200*				
Ordinary Shares—							
Old .	1,000	1,000	[3] 600				
New .		*400*	*200*				
£	11,400	£11,400	£11,000	£	11,400	£11,400	£11,000

The respective positions may be illustrated thus—

	(a) £	(b) £	(c) £
Profits (say)	1,100	1,100	1,100
Amount required to meet Preference Dividends of 6% . .	624	600	612
Surplus . .	£476	£500	£488

DISTRIBUTION OF PROFITS

	(a) £	(b) £	(c) £
Old Preference Shareholders as holders of—			
(i) New Preference Shares	624	600	612
(ii) New Ordinary Shares in respect of "Arrears" .		(x) 143	(y) 122
Old Ordinary Shareholders as holders of New Ordinary Shares	476	(x) 357	(y) 366
	£1,100	£1,100	£1,100

(x) Respectively $\frac{400}{1,400}$ and $\frac{1,000}{1,400}$ of £500. (y) Respectively $\frac{200}{800}$ and $\frac{600}{800}$ of £488.

It has been assumed so far that the preference shareholders have a preference as to dividends, and according to the arrangements shown above, they not only suffer no abridgment of this privilege, but they obtain a return on their "arrears." Thus they obtain the income equivalent to actually receiving the amount of the "arrears" "free of tax," and reinvesting it in some form or other, whilst at the same time their capital position suffers no contraction.

If they have no preference as to *capital* and are, therefore, on the same level as the ordinaries, it might be considered that they ought to share a due proportion of the capital loss. If this is to be effected, it might be done by reducing the share capital by proportionate amounts; but in order to preserve to them the same amount

[1] I.e. £11,000 (as shown on page 1021) plus £400.
[2] £11,000 only, £400 being taken from the old ordinary shareholders.
[3] £1,000 less £400 given to preference shareholders.

of dividend, the rate of dividend would have to be considerably increased. This is usually a very unwise procedure. Consequently, a new class of share might be created of comparatively small dimensions and given to the preference shareholders, entitling them to dividends, requisite to bring the return to that originally obtained; with a small participation in the surplus, after payment of a certain rate to the ordinary shareholders, to compensate them for loss of priority of dividend; alternatively, the preference shareholders may be induced to take new preference shares reduced in rate and a comparatively small number of ordinary shares, the incentive offered being that, whilst the preference shareholders will receive less as preference dividend, they will receive more of the ultimate surplus profits.

Winding-up Aspect of Reconstructions. The problem raised by this aspect differs materially from that previously dealt with in reference to the prospective yield on the shareholding as reconstituted. Here the assets and their probable realization are a matter of primary importance; whereas, whilst the company is dividend-producing, the mere book denomination of the share is of secondary importance.

Where the preference shareholders have no priority as to capital, they stand on the same footing as the ordinary shareholders, so that if the respective capitals are revised, it can be readily seen that the greater the proportion of capital, the greater the return. Further, if the preference shareholders have the right to share in a surplus in the winding up (which they do not possess if preferential as to capital unless the articles expressly so state) such surplus will be divisible proportionately to capitals.

Where the preference share capital remains *unaltered*, and the holders possess no right to share in a surplus in the winding up, the position is simple. The preference shareholders obtain the same undiminished right of return of capital, but thereafter everything belongs to the ordinary shareholders.

Where the preference shareholders have the right to participate in a capital surplus arising in a winding up, the important matters for them are—

(1) preserving their original capital;

(2) the sharing of the SURPLUS.

So far as relates to the ordinary shareholders, they are concerned, first, in the repayment of their capitals, so that the smaller the preference share capital the greater is the possibility of a repayment to them; whilst, secondly, they are concerned in obtaining the return of their ORIGINAL capital (if possible), so that, in addition to being interested in cutting down the amount of preference share capital, they wish to see their own capital as large as possible, because after payment of the preference share capital, they will receive all the remaining surplus up to the extent of their *revised* capital, and the higher the relative proportion of the ordinary capital to the preference capital the more favourable is the ordinary shareholder's position.

Where the preference shareholders have the right to participate in the surplus the same principle applies (as mentioned on page 1023).

Illustration. The share capital of X, Ltd., is 2,000 preference shares and 2,000 ordinary shares all of £1 each fully paid. The preference have priority and participation rights in winding up. Assuming that the assets realize (on liquidation) £3,200, show in columnar form the respective positions assuming (1) no reconstruction, (2*a*) a reconstruction by which the preference shares were cut down by £500 and the ordinary shares by £1,000, (2*b*) a reconstruction by which the preference shares were cut down by nil and the ordinary shares by £1,500.

	(1)		(2*a*)		(2*b*)	
	Preference	Ordinary	Preference	Ordinary	Preference	Ordinary
Repayment of Capitals—	£	£	£	£	£	£
Preference . . .	2,000		1,500		2,000	
Ordinary . . .		1,200		1,000		500
Surplus (*pari passu*) .	Nil	Nil	420	280	560	140
	£2,000	£1,200	£1,920	£1,280	£2,560	£640

Illustration. X, Ltd., has a share capital of 5,000 7 per cent preference shares and 5,000 ordinary shares, all of £1 each fully paid. There is a capital loss of £4,000, of which £1,000 is to be borne by the preference shareholders and the balance by the ordinary shareholders. On liquidation the assets realize £15,000 after all expenses and creditors have been paid. The profits were: Years 1, 2, 3, and 4, £300, £350, £600, and £1,000 respectively.

Set out in tabular form the respective positions of the two classes of shares, contrasting them: (1) assuming no reconstruction; (2) on the basis of the above reconstruction.

(i) Where the preference shares are non-cumulative and without preference as to repayment of capital, or right to participate in surplus (all profits have been paid in dividends)—

Yearly Profits and Dividends; and Repayment of Capitals		Total	(1)				Total	(2)			
			Preference		Ordinary			Preference		Ordinary	
Dividends—	£	£	£	£	£	£	£	£	£	£	£
Year 1 . .	[1] 300		Nil		Nil			280		20	
,, 2 . .	350		350		300			280		70	
,, 3 . .	600		350		250			280		320	
,, 4 . .	1,000	*2,250*	350	1,050	650	1,200	*2,250*	280	1,120	720	1,130
Repayment of Capitals—											
Preference	5,000			5,000			*4,000*		4,000		
Ordinary .	5,000				5,000					2,000	
Surplus to Ordinary	5,000	*15,000*			5,000	10,000	*11,000*			9,000	11,000
	£	*17,250*		£6,050	£	11,200	*£17,250*		£5,120	£	12,130

[1] It is assumed that the directors decide not to recommend the payment of the preference dividend in this year inasmuch as the profits do not wholly cover it. If £300 [i.e. 6% on the preference shares] was paid there would be no dividend on the ordinary shares in Year 2.

(ii) Where the preference shares are cumulative and without preference as to repayment of capital, or right to participate in surplus (all profits have been paid in dividends)—

Yearly Profits and Dividends; and Repayment of Capitals		Total	(1) Preference		Ordinary		Total	(2) Preference		Ordinary	
Dividends—	£	£	£	£	£	£	£	£	£	£	£
Year 1 .	300		Nil		Nil			280		20	
" 2 .	350		350		Nil			280		70	
" 3 .	600		[1]700		200			280		320	
" 4 .	1,000	2,250	350	1,400	650	850	2,250	280	1,120	720	1,130
Repayment of Capitals— As in (1)		15,000		5,000		10,000	15,000		4,000		11,000
	£	17,250		£6,400	£	10,850	£17,250		£5,120	£	12,130

(iii) Where the preference shares are cumulative without preference as to repayment of capital or right to participate in surplus, but the right to have "arrears" paid on dissolution. (No dividends have been paid.)—

Yearly Profits and Repayment of Capitals.		Total	(1) Preference		Ordinary		Total	(2) Preference		Ordinary	
Dividends—	£	£	£	£	£	£	£	£	£	£	£
Year 1 .	300			Nil		Nil			Nil		Nil
" 2 .	350			Nil		Nil			Nil		Nil
" 3 .	600			Nil		Nil			Nil		Nil
" 4 .	1,000			Nil		Nil			Nil		Nil
	£2,250										
Repayment of Capitals— Preference "Arrears"		1,400	1,400				1,120	1,120			
Preference Capital		5,000	5,000	6,400			4,000	4,000	5,120		
Ordinary		5,000			5,000		2,000			2,000	
Surplus to Ordinary		5,850			5,850	10,850	10,130			10,130	12,130
	[2]£	17,250		£6,400	£	10,850	£17,250		£5,120	£	12,130

(iv) Where the preference shares are non-cumulative, with preference as to repayment of capital, together with the right to participate in surplus (all profits have been paid in dividends)—

[1] Assumed arrears cleared in Year 3.

[2] For the purpose of comparison the sum of £17,250 has been taken as the amount available for distribution in the dissolution, i.e. £15,000 and £2,250 profits which have not been distributed.

It is assumed that "surplus" covers both that of capital and of revenue.

Yearly Profits and Dividends; and Repayment of Capitals	Total	(1) Preference		(1) Ordinary		Total	(2) Preference		(2) Ordinary	
	£	£	£	£	£	£	£	£	£	£
Dividends (*as in* i).	*2,250*		1,050		1,200	*2,250*		1,120		1,130
Repayment of Capitals—										
Preference .	*5,000*	5,000				*4,000*	4,000			
Ordinary .	*5,000*			5,000		*2,000*			2,000	
Surplus (*pari passu*) .	*5,000*	2,500		2,500		*9,000*	6,000		3,000	
			7,500		7,500			10,000		5,000
£	*17,250*		£8,550		£8,700	*£17,250*	£	11,120		£6,130

(v) Where the preference shares are cumulative, with preference as to repayment of capital, together with the right to participate in surplus (all profits have been paid in dividends)—

Yearly Profits and Dividends; and Repayment of Capitals	Total	(1) Preference	(1) Ordinary	Total	(2) Preference	(2) Ordinary
	£	£	£	£	£	£
Dividends (*as in* ii) .	*2,250*	1,400	850	*2,250*	1,120	1,130
Repayment of Capitals (*as in* iv) . .	*15,000*	7,500	7,500	*15,000*	10,000	5,000
	£17,250	£8,900	£8,350	*£17,250*	£11,120	£6,130

(vi) Where the preference shares are cumulative without preference as to repayment of capital or right to participate in a CAPITAL surplus, but the right to have "arrears" paid on dissolution, together with REVENUE surplus. (No dividends have been paid.)—

Yearly Profits and Repayment of Capitals		Total	(1) Preference		(1) Ordinary		Total	(2) Preference		(2) Ordinary	
Dividends —	£	£	£	£	£	£	£	£	£	£	£
Year 1 .	300										
,, 2 .	350										
,, 3 .	600										
,, 4 .	1,000		Nil			Nil		Nil		Nil	
	£2,250										
Repayment of Capitals—											
Preference "Arrears"		*1,400*	1,400				*1,120*	1,120			
Preference Capital .		*5,000*	5,000				*4,000*	4,000			
Revenue Surplus to Preference .		*850*	850				*1,130*	1,130			
				7,250					6,250		
Ordinary .		*5,000*			5,000		*2,000*			2,000	
Surplus to Ordinary		*5,000*			5,000	10,000	*9,000*			9,000	11,000
	£	*17,250*		£7,250	£	10,000	*£17,250*		£6,250	£	11,000

It should be noted that in the circumstances outlined the fact that there is sufficient to pay both the preference and the ordinary

capitals in full obviously gives no advantage to the former even if they have a preference as to repayment of capital, but the distinctions have been made to explain the principles involved.

The principles outlined are just the same, even if the "arrears" of cumulative preference dividends are compounded in the form of share capital, the amounts receivable depending upon the results on the relative capitals remaining for the preference and ordinary shareholders.

Where there is a new class of share introduced, and even if there are several grades of shares already existing, e.g. preference, ordinary, and deferred, although the detail may become involved, the above principles are nevertheless applicable.

The difficulties of reconciling the conflicting positions arising in respect of dividends and capital repayments in a winding-up are often considerable, seeing that rights to dividends (particularly as regards ordinary shareholders) do not depend necessarily on book value of shareholdings, whilst the repayment rights in a winding-up depend primarily upon the proportions of book value of shareholdings of various classes.

It is important to remember, therefore, that regard must be had to—

(1) Dividend aspect.

(2) Winding-up aspect according to—

(*a*) Whether preference shareholders have a right to priority in repayment of capital or not.

(*b*) Whether the preference shareholders have the right to participate in surplus assets remaining after payment of costs, liabilities and repayment of capitals.

(*c*) Whether the " arrears " of cumulative preference dividends are to be paid and, if so, in what priority.

The question as to whether the reorganization involves the issue of partly paid shares is important particularly from the winding up aspect.

In both cases the range of profits and the possibility of the assets realizing an amount (*a*) insufficient, (*b*) sufficient to repay original capitals; and in (*b*) the possibility of a small or large surplus over the *original* capital must be considered, as must the nature of the surplus.

It should be clear to the student that surplus means the amount remaining after payment of (1) *all* costs and expenses; (2) creditors, including DEBENTURE holders; (3) book values of share capitals (i.e. as they exist at the commencement of winding up).

It may be mentioned in connection with the dividend aspect that the greater the amount of reduction of capital applied against fixed assets, the less will be the charge in the future for depreciation, thus enhancing the amount of profits; although the reflex action will take place when such fixed assets are to be replaced, when the depreciation charge will considerably increase.

In dealing with the above examples, it has not been thought necessary to repeat the fact of the importance of VOTING rights (mentioned on page 1017), but this is an exceedingly important matter.

In examination problems the student will have neither time nor opportunity to deal in detail with all phases already outlined; but he will be expected to pay prime attention to the dividend aspect, with a brief reference to the winding-up position, as this is comparatively less important than the former; yet an understanding of the guiding principles of the latter should be known.

As a matter of practice, it is quite impossible to view the winding-up position with certainty, the contingencies being so very numerous and frequently utterly incapable of even an approximate prognostication.

It is, therefore, a matter of importance not only to bestow great care in the formulation of the scheme of reconstruction, but to choose carefully the opportune time. The necessity for the latter precaution may cause a delay not only of weeks, but of months, before a fair, equitable, and workable scheme can be prepared so as to meet with the approval of all interested parties.

Illustration. A company has passed through a period of heavy losses and, in the opinion of the directors after full consideration, the time to deal with the reconstruction has arrived. Its Balance Sheet at 30th June, 1953, may be summarized as follows—

BALANCE SHEET AS AT 30TH JUNE, 1953

	£		£
Share Capital Authorized and Issued—		Goodwill at Cost . .	10,000
100,000 6% Cumulative Preference Shares of £1 each . . .	100,000	Works and Plant at Cost, *less* Depreciation . .	110,000
130,000 Ordinary Shares of £1 each . .	130,000	Stock, Work in Progress, Book Debts, Cash, *less* Trade Liabilities . .	31,000
(*Note.* The cumulative dividend on the Preference Shares has been paid up to 31st December, 1951.)		Profit and Loss Account .	79,000
	£230,000		£230,000

Each share (both preference and ordinary) carries one vote. On a liquidation the cumulative preference share capital is repayable at par plus any "arrears" of dividend, and ALL surplus goes to the ordinary shareholders.

It is *believed* that the net profits in future will *average* £12,000 per annum. The floating assets, less liabilities, are considered to be worth the book figure of £31,000; goodwill is considered valueless; works and plant are revalued at £101,500.

A recapitalization being desired, you are requested to reframe the Balance Sheet as it would appear after giving effect to such

recapitalization (involving a reduction in the nominal amount of the issued share capital) as you consider would be likely to commend itself to both the preference and the ordinary shareholders. Show how the rights of each class would be altered under the scheme you propose.

The company desires to avoid the creation of a *new* class of shares.

Before dealing with the scheme, the student will observe that the words in italics are important, and it will be advisable to preface the answer by stating the assumptions that there is sound justification for the belief, and that the yearly profits will not fluctuate unduly from the average of £12,000.

The question confines the scope by reason of the statements that—

(1) The preference capital is repayable at par, plus "arrears."

(2) The ordinary shareholders are entitled to any surplus.

(3) The preference shareholders have priority in the winding up.

(4) The scheme is to provide for some diminution of the nominal value of the preference shares, as well as the ordinary shares.

(5) No new class of shares is to be created.

On the other hand, the question contains no information as to the possibility of the company requiring additional working capital, nor the amount and security of the creditors. This may be commented on, but ignored in the working of the problem.

REFRAMED BALANCE SHEET AS AT 30TH JUNE, 1953

	£		£
Authorized Share Capital—		Works and Plant at Cost, *less* Depreciation, less amounts written off under Scheme . .	101,500
100,000 7% Preference Shares of 17s. 6d. each .	87,500	Stock, Work in Progress, Book Debts, Cash, *less* Trade Liabilities . .	31,000
712,500 Ordinary Shares of 4s. each . . .	142,500		
Issued Share Capital—			
100,000 7% Preference Shares of 17s. 6d. each fully paid . . (*a*)	87,500		
180,000 Ordinary Shares of 4s. each fully paid (*b*)	36,000		
5% Income Certificates of 6s. each . . (*c*)	9,000		
	£132,500		£132,500

The preference shareholders will receive— £

		£
(1) One new 7% Preference Share of 17s. 6d. fully paid in exchange for one old Preference Share . . .	= 100,000 at 17s. 6d.	87,500 (*a*)
(2) One new Ordinary Share of 4s. fully paid for two old Preference Shares . .	$= \frac{100{,}000}{2}$ = 50,000 at 4s.	10,000 (*b*)

(3) Three 5% Income Certificates of 6s. each for every ten old Preference Shares for $1\frac{1}{2}$ years' "arrears" [£9,000]	$= \frac{3}{10} \times 100{,}000 = 30{,}000$ at 6s.	£ 9,000	(c)

The ordinary shareholders will receive—

One new Ordinary Share of 4s. fully paid for one old Ordinary Share	= 130,000 at 4s	26,000	(b)

Alternatively, the following scheme might be suggested. The preference shareholders will receive—

(1) One new 8% Preference Share of £1 fully paid for two old Preference Shares .	$= \frac{100{,}000}{2} = 50{,}000$ at £1	£ 50,000
(2) One new Ordinary Share of 7s. 6d. each fully paid for two old Preference Shares	$= \frac{100{,}000}{2} = 50{,}000$ at 7s 6d.	18,750
(3) One 5% Income Certificate of 6s. for two old Preference Shares. . .	$= \frac{100{,}000}{2} = 50{,}000$ at 6s.	15,000

The ordinary shareholders will receive—

One new Ordinary Share of 7s. 6d. fully paid in exchange for one old Ordinary Share .	= 130,000 at 7s. 6d.	48,750

The position of the shareholders before and after the scheme may be contrasted, as well as the relative position as between alternative schemes with reference to the profits of £12,000 indicated in the question, on the lines shown in the succeeding illustration.

Illustration. Z, Ltd., proposes the following scheme of reconstruction—

The issued share capital is to be reduced by £110,339 by (*a*) writing 5s. off each 8 per cent £1 cumulative preference (participating) share, each reduced preference share to be subdivided into one *non-cumulative* 8 per cent preference share of 10s. fully paid and one ordinary share of 5s. fully paid; (*b*) by writing 15s. off each of the £1 ordinary shares. The preference dividends in "arrears" for nine years are to be cancelled.

The preference shareholders are at present entitled to 25 per cent of surplus profits after payment of (*a*) their 8 per cent cumulative dividend; (*b*) 20 per cent of remaining profits to a fund for redeeming certain certificates issued in 1935 in lieu of three years' preference dividend "arrears"; and (*c*) 10 per cent on the ordinary shares. Under the scheme 20 per cent of remaining profits to fund in (*b*) above is to be continued.

The Balance Sheet (abridged) before the scheme is as follows—

BALANCE SHEET

	£		£
Issued Share Capital—		Sundry "Net" Assets .	347,114
8% Cumulative Preference Participating Shares of £1 each fully paid	299,993		
Ordinary Shares of £1 each fully paid . .	47,121		
	£347,114		£347,114

You are required (A) to show the Balance Sheet after the scheme has been sanctioned; and (B) to make brief comments on the scheme itself. Ignore the winding-up aspect, and nominal capital.

(*A*) BALANCE SHEET (*after* RECONSTRUCTION)

	£	s.	d.		£	s.	d.	£	s.	d.
Issued Share Capital —										
8% Non-cumulative Preference Shares of 10s. each fully paid					149,996	10	0			
Ordinary Shares of 5s. each fully paid—										
[1] [Allotted to Old Preference Shareholders]	74,998	5	0							
[2] [Allotted to Old Ordinary Shareholders]	11,780	5	0							
					86,778	10	0			
				Sundry "Net" Assets . .				236,775	0	0
					£236,775	0	0	£236,775	0	0

(*B*) The following points emerge from the scheme—

(1) The preference shareholders sacrifice nine years' dividends and relinquish a substantial claim on future profits.

(2) Although the rate of dividend remains the same, the preferential right of the preference shares to dividends is reduced by exactly half.

(3) The preference shareholders lose entirely their cumulative and (for what they are worth) their participating rights.

(4) As against the above, the preference shareholders are given over 86 per cent of the "equity" of the business which will tend to compensate them for the relinquishment of the participating rights. In fact, the scheme clearly separates the "preferential" from the "equity" rights and simplifies the position.

(5) The old ordinary shareholders have less preference capital ranking in front of them for dividend, but as a result of the scheme have less than 14 per cent of the equity of the business.

(6) The scheme releases for payment to ordinary shareholders future profits, as otherwise they would be charged with the nine years' "arrears" of preference dividends, together with current preference dividends on £299,993, as against £149,996 10s.

[1] Proportion of "equity" = 86% approximately.
[2] Proportion of "equity" = 14% approximately.

(7) As the proportion set aside for certificate redemption is increased (as shown below) the current divisible profits are reduced, but this allocation will cease when the amount required to pay off the certificates has been raised.

In short, the old preference shareholders forgo all claims based on the past, but secure the substantial and major share of the "equity"; whilst the old ordinary shareholders, in consideration of obtaining dividends at an early stage, sacrifice in favour of the old preference shareholders the bulk of their "equity."

The effects of the scheme may be gauged by assuming divisible profits of £10,000, £30,000, and £50,000. The comparative positions would be—

Profits	Old Preference Shareholders		Old Ordinary Shareholders	
	Before Scheme	After Scheme	Before Scheme	After Scheme
£	£	£	£	£
10,000	10,000	10,000 [1]	Nil	Nil
* [2] 30,000	(a) 24,022	(b) 24,445	(a) 4,778	(b) 1,955
50,000	28,022	38,273	16,778	4,127

* These amounts are arrived at as follows—

POSITION *before* SCHEME

			Preference Shareholders	Ordinary Shareholders
		£	£	£
Profits		30,000		
Less 8% Dividend on Preference Shares		24,000	24,000	
		6,000		
Less 20% Provision for Certificate Redemption . [2].		1,200		
		4,800		
Less 10% Dividend on Ordinary Shares		4,712		4,712
		88		
Divisible—	£			
25% thereof for Preference Shareholders .	22		22	
75% thereof for Ordinary Shareholders .	66			66
	—	88		
			£24,022	£4,778

[1] Allowing nothing for provision for redemption of certificates. The calculations are made upon the assumption that the preference shares were £300,000, the difference of 7 being signatories' shares.

[2] The total profits divided before the scheme were £28,800 (see (a) above), and after the scheme £26,400 (see (b) above), the diminution of £2,400 arising from the increased allocation to Certificate Redemption Fund (as shown above and on page 1033).

POSITION *after* SCHEME

		Old Preference Shareholders	Old Ordinary Shareholders
	£	£	£
Profits	30,000		
Less 8% Dividend on 299,993 Preference Shares of 10s. each	12,000	12,000	
	18,000		
Less 20% Provision for Certificate Redemption . [1].	3,600		
	14,400		
Payable as Dividend on Ordinary Shares—			
(i) 299,993 of 5s. each £12,445		12,445	
(ii) 47,121 of 5s. each 1,955			1,955
	14,400		
		£24,445	£1,955

[1] See note 2, page 1032.

Calculations based actually upon 300,000 shares (see note 1, page 1032).

The profits available for distribution to the ordinary shareholders are divisible in the proportion of 299,993 : 47,121.

The calculation for the division of the profits of £50,000 will be similarly made.

In all cases the resultant voting power must be carefully noted.

Examination Problem

The following reconstruction scheme is approved by a majority of the shareholders of a public company with a capital of £600,000 in fully-paid shares of £1 each.

A new company is to be formed, to take over the entire undertaking of the original company, with a capital of £600,000 in shares of 10s. each. Original shareholders are to have the right to apply for five shares in the new company, paid up to the extent of 8s. per share, for every three shares of the old company. Cash creditors, amounting to £30,000 are to be paid off, and the costs of the scheme, £3,000, are to be paid by the new company.

Assume that, in due course, all the original shareholders applied for, and were allotted, the shares in the new company to which they were entitled, a call of 1s. per share was made, and the creditors and costs were paid as arranged.

Show—

(i) The issued share capital of the new company as it will appear on the Balance Sheet.

(ii) The reserve, if any, available for writing down assets.

(iii) The cash available for the new company.

(*Institute of Chartered Accountants Inter.*)

(i) Issued Share Capital—	£
1,000,000 shares of 10s. each, 9s. paid .	450,000

	£	£
(ii) Capital Reserve—		
Paid-up value of shares in old company ["net" assets]		600,000
Less shares issued in exchange, 1,000,000 credited with 8s. paid	400,000	
costs of scheme	3,000	
		403,000
Amount available for writing down assets		£197,000

	£	£
(iii) Cash available for new company—		
Call, 1,000,000 shares, 1s. each		50,000
Less creditors paid off	30,000	
costs of scheme	3,000	
		33,000
Net cash available		£17,000

[The above question will be answered easily if the entries are journalize and posted to rough Ledger Accounts.]

Miscellaneous. Many difficulties may arise in practice, even in th case of comparatively simple amalgamations, and the following ar probably the more important matters which must be considered—

(1) The method most likely to receive the requisite approval of members e.g. approval of 90 per cent in value required before compulsory share acquis tion powers of Section 209, Companies Act, 1948, operate, special resolutio only required to authorize liquidator to accept shares, etc. in consideration fo transfer of business or property under Section 287.

(2) The taxation advantages and disadvantages of the various methods.

(3) The "freezing" of revenue reserves as pre-acquisition profits. Where holding company is to acquire the share capitals of two or more existin companies, all reserves of the latter will be frozen (except possibly for profit earned subsequent to a prior takeover date as from which the shares ar acquired) but the reserves of one of the existing companies can remain fre if it becomes the holding company and, if desired, sells its undertaking to new subsidiary company in exchange for shares.

(4) The requirement of Section 56, Companies Act, 1948, for a company where applicable, to raise a Share Premium Account whether its shares ar issued for cash *or otherwise* (vide *Henry Head & Co., Ltd.* v. *Ropner Holdings Ltd.*, where a holding company which had acquired subsidiaries by an exchang of shares had to create a Share Premium Account equal to the differenc between the nominal value of the shares it issued and the true value of th assets acquired as represented by the shares of the subsidiary companies) This treatment results in an automatic freezing of pre-acquisition profits.

CHAPTER XXIV

HOLDING COMPANIES

IT has been seen in connection with Company Accounts that one form of merger takes place by the medium of the Holding Company. The procedure, it will be remembered, is not to acquire the ASSETS with or without LIABILITIES of the absorbed company, but its SHARES. The separate entity of the absorbed company remains undisturbed, the acquiring company paying out, or discharging in other ways, the claims of the shareholders of the absorbed company. Consequently, no entries are required in the financial books of the latter company, as the transaction merely involves the transfer of shares from the old shareholders to the new holder (the acquiring company) with the consequent alterations in the Register of Members.

Definition of Holding Company and Subsidiary Company. Section 154, Companies Act, 1948, states—

(1) For the purposes of this Act, *a company shall*, subject to the provisions of subsection (3) of this section, *be deemed to be a subsidiary of another if, but only if—*

(*a*) *That other either—*

(i) *Is a member of it and controls the composition of its board of directors; or*

(ii) *Holds more than half in nominal value of its equity share capital; or*

(*b*) *The first-mentioned company is a subsidiary of any company which is that other's subsidiary.*

(2) For the purposes of the foregoing subsection, the composition of a company's board of directors shall be deemed to be controlled by another company if, but only if, that other company by the exercise of some power exercisable by it without the consent or concurrence of any other person can appoint or remove the holders of all or a majority of the directorships; but for the purposes of this provision that other company shall be deemed to have power to appoint to a directorship with respect to which any of the following conditions is satisfied, that is to say—

(*a*) That a person cannot be appointed thereto without the exercise in his favour by that other company of such a power as aforesaid; or

(*b*) That a person's appointment thereto follows necessarily from his appointment as director of that other company; or

(*c*) That the directorship is held by that other company itself or by a subsidiary of it.

(3) In determining whether one company is a subsidiary of another—

(*a*) Any shares held or power exercisable by that other in a fiduciary capacity shall be treated as not held or exercisable by it;

(*b*) Subject to the two following paragraphs, any shares held or power exercisable—

(i) By any person as a nominee for that other (except where that other is concerned only in a fiduciary capacity); or

(ii) By, or by a nominee for, a subsidiary of that other, not being a subsidiary which is concerned only in a fiduciary capacity;

shall be treated as held or exercisable by that other;

(*c*) Any shares held or power exercisable by any person by virtue of the

provisions of any debentures of the first-mentioned company or of a trust deed for securing any issue of such debentures shall be disregarded;

(*d*) Any shares held or power exercisable by, or by a nominee for, that other or its subsidiary (not being held or exercisable as mentioned in the last foregoing paragraph) shall be treated as not held or exercisable by that other if the ordinary business of that other or its subsidiary, as the case may be, includes the lending of money and the shares are held or power is exercisable as aforesaid by way of security only for the purposes of a transaction entered into in the ordinary course of that business.

(4) For the purposes of this Act, *a company shall be deemed to be another's holding company if, but only if, that other is its subsidiary.*

(5) In this section, the expression "company" includes any body corporate, and *the expression "equity share capital" means, in relation to a company, its issued share capital excluding any part thereof which, neither as respects dividends nor as respects capital, carries any right to participate beyond a specified amount in a distribution.*

From this it will be seen that, before a subsidiary/holding company relationship can exist, there must, subject to direct and indirect holdings and control, be beneficial ownership of more than one-half in nominal value of the equity share capital or share ownership combined with power to control the composition of the board of directors. The definition, however, embraces sub-subsidiaries and other companies where the requisite share-ownership or power of control is held by two or more companies in a group. To constitute equity share capital there must be the right to participate without limit in a distribution of *either* dividend *and/or* capital.

Advantages and Disadvantages of Holding Companies. The advantages are—

(1) Preservation of separate entities, thus avoiding the sacrifice of the goodwill of the subsidiary company.

(2) Different accounting periods may be used where in the opinion of the directors there are good reasons for doing so, although otherwise as will be seen later Section 153 of the Companies Act, 1948, requires the same period to be used for the holding company and its subsidiaries to facilitate the preparation of group accounts.

(3) Losses of a subsidiary company previously incurred may be carried forward for Income Tax purposes together with capital allowances, if any; whereas by an ordinary amalgamation the absorbed company, no longer being an entity, would sacrifice such right.

(4) Clear results of the operations and of the financial position of each constituent part are easily ascertained by the management, although the Consolidated Balance Sheet will disclose only matters that relate to the group as a whole.

(5) By the simple expedient of selling shares in the subsidiary, the holding company can release its control or indeed the whole of its interest in the subsidiary.

The disadvantages are (in addition to those attendant upon *any* amalgamation)—

(1) Danger of fraudulent flotation and manipulation.

(2) Danger of oppression of minority shareholders.

(3) Lack of information to HOLDING COMPANY members as to the real worth of the investments in the subsidiary companies, although this is now obviated to some extent by the compulsory submission of group accounts.

(4) Favouritism. One section may be allowed to sell at exorbitant prices to another section; advancement of moneys to a constituent company at excessive interest, or conversely, at unremunerative interest or without security.

(5) Resulting from (4), the position of creditors and other members of the subsidiary company may be jeopardized.

(6) Excessive Directors' Fees. Several or all directors of the holding company may join the Board and receive excessive fees from the subsidiary company.

(7) Accounting difficulties, e.g. in dealing with the valuation of stocks and proper recording of inter-company transactions.

(8) Where the subsidiary company is quoted on the Stock Exchange, the limited number of minority shares may prevent a "free" market in the shares.

(9) It is difficult to appraise the true earning capacity of subsidiary companies.

(10) Profits and losses of individual subsidiary companies are not usually disclosed, although under the Companies Act, 1948, Balance Sheet and accounts will have to be filed with the Annual Return.

Creation of the Holding Company. The Holding Company may come into existence—

(*a*) Entirely as a new company to acquire all or a majority of the shares in (i) new companies and/or (ii) already existing companies for either (1) Cash and/or (2) Shares exchange.

(*b*) By an already existing company forming new companies or taking over existing companies by way of development and expansion.

Particularly as regards new companies formed, the purpose may be (*a*) to oust weaker rivals, (*b*) to "departmentalize" activities, e.g. formation of companies in particular areas (including overseas) or with limited functions such as supplying raw materials, manufacturing, carrying out repair work, marketing the finished products, or in exceptional cases, to carry out all the operational functions.

A particular difficulty arises where shares are acquired from shareholders of existing companies (as distinct from those formed by the Holding Company where all the shares in the new companies can be acquired) by reason of the inability to acquire all the shares of the existing companies, as some shareholders will not or cannot sell their shares. These shareholders form, almost invariably, a minority, and the terms majority (or controlling) interest and minority (or outside) interest are used to denote the shareholding of the Holding Company and the other shareholders respectively.

It has been seen that the essential factor is that the company

holding shares in other companies (*a*) does so deliberately to obtain control and (*b*) does, in fact, exercise directly or indirectly such control of the activities of those other companies.

The law has laid down certain minimum requirements in order to bring companies within the rules appertaining to Holding Companies and Subsidiary Companies, but in order to exercise undoubted and paramount control a Holding Company ought (from the business point of view) to be in a position to force through an extraordinary and special resolution—which requires a majority of not less than three-quarters of the shareholders entitled to vote (and voting) at a meeting called for the purpose of passing such a resolution, so that effective voting power is essential. On the other hand, companies (even if not Holding Companies as defined by the Companies Act, 1948) do dominate the destinies of companies in which they have substantial holdings, although well below 50 per cent as (1) many, in fact most, shareholders neither attend meetings nor trouble to fill up a proxy form, (2) even if they do attend they may not cast their vote, (3) they may be at variance with other shareholders when important issues arise so that the voting power of the substantial shareholder often scores over the divided votes of the other shareholders, and (4) many shareholders follow the lead of the big shareholder.

Book-keeping Entries in the Holding Company. On the purchase of the shares the acquiring company (holding company) will debit Shares in Subsidiary Company Account and credit Cash, Share Capital, or Debentures Account, according to the manner in which the claims of the shareholders of the absorbed company are satisfied.

With regard to dividends received by the holding company from a subsidiary company, only the dividends out of *profits made after the date of the purchase by the holding company* can be credited to the Profit and Loss Account of the latter.

Illustration. The following is the Balance Sheet in abridged form of S, Ltd., all the shares of which are purchased at the date of the Balance Sheet by H, Ltd., for £8,000.

S. Ltd., Balance Sheet

	£		£
Share Capital (£1)	3,000	Sundry Assets	9,000
Reserve	3,300		
Profit and Loss Account	1,700		
Creditors	1,000		
	£9,000		£9,000

Although in law the holding company has acquired *shares*, the accounting must have regard to net assets acquired. These are £9,000 assets, less creditors £1,000. This balance is reflected in share capital £3,000 and undistributed profits of £5,000, so that whenever the latter are paid out in dividends, the receipt in the

books of the holding company must be treated as a return of the purchase price; this can readily be seen if it is assumed that on the day following the purchase this has been done. The Balance Sheet will be—

S. LTD., BALANCE SHEET

	£		£
Share Capital . . .	3,000	Sundry Assets . . .	4,000
Creditors	1,000		
	£4,000		£4,000

The Investment Account of the holding company would appear thus—

Dr. SHARES IN SUBSIDIARY COMPANY *Cr.*

		£			£
To Cash for Purchase of 3,000 Shares of £1 each at £2 13s. 4d. a share .		8,000	By Dividend received in respect of Profit prior to Purchase .		5,000
			,, Balance . . .	c/d	3,000
		£8,000			£8,000
To Balance . . .	b/d	3,000			

Dividends from a subsidiary company out of its profits earned *subsequent* to the purchase of the shares by the holding company will be credited to Profit and Loss Account in the books of the latter.

In regard to losses, these may have been incurred before or after the purchase by the holding company. The losses incurred prior to the purchase by the holding company would normally be taken into account in estimating the value of the shares acquired, so that all subsequent profits may be properly credited, upon the payment of dividends, in the books of the holding company. In regard to losses incurred since the date of the acquisition by the holding company, it is usual to create a provision therefor in the books of the latter and show it as a deduction from the investment in the Balance Sheet.

It is an unsound practice to bring into account the profit of the subsidiary otherwise than by way of dividends received, but if this is done the amount should be shown separately in the Balance Sheet of the holding company.

Illustration. On 1st April, 1952, Holdings, Ltd., purchased 18,000 ordinary shares of £1 each fully paid in Sub, Ltd., at £2 5s. a share. On 31st December, 1952, the latter company paid a dividend of 75 per cent, together with a bonus share dividend of "one for three."

The Profit and Loss Appropriation Account of Sub, Ltd., was in credit as follows—

Cr.

		£
1951 Dec. 1	By Balance brought forward	20,000
1952 Nov. 30	,, Profit for the Year brought down . . .	12,000
		32,000

The issued share capital of Sub, Ltd., was £20,000 in ordinary shares of £1 each fully paid.

Ignoring income tax and narratives, show the Journal entries of Holdings, Ltd., in respect of the cash and bonus dividends on the shares held in Sub, Ltd.

(1) CASH DIVIDEND—

In all cases of this type it must be decided whether the dividend is to be considered as being paid out of current profits, or out of the balance of Profit and Loss Account brought forward, or partly out of each. Depending upon this consideration, the entries will be—

(*a*) Current profits utilized as far as possible (this solution is based on the principle that dividends are paid, in the absence of other information, out of the latest available profits).

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			£	£
1952 Dec. 31	Cash . . . . *Dr.*		13,500	
	To Investment (or Shares) in Sub, Ltd.			6,300
	,, Dividends Receivable . . .			7,200

The above dividend is partly capital and partly income, the latter being $\frac{8}{12}$ths of 90 per cent of £12,000, representing the accruing income from the date of purchase (1st April, 1952) to the end of the financial year (30th November, 1952) on 18,000 shares, being 90 per cent of the issued share capital of Sub, Ltd.

The apportionment is analogous to that required in Executorship Accounts and, strictly, should be calculated in days, i.e. $\frac{244}{366}$ of 90 per cent of £12,000.

(*b*) If paid out of the balance of Profit and Loss Account the whole of the dividend will be credited to the Investment Account.

(*c*) The third alternative is to split the dividend between the balance forward and the current year's profit in proportion to their respective amounts, so that as far as Holdings' 90 per cent share of the £15,000 dividend is concerned, the allocation is—

Balance Forward . . $90\% \times \frac{20,000}{32,000} \times £15,000 = £8,437$ 10s.

Current Profit . . $90\% \times \frac{12,000}{32,000} \times £15,000 = £5,062$ 10s.

As, however, the latter is for the year to 30th November and the shares were purchased on 1st April, only $\frac{8}{12}$ths of this can be regarded as income. The entries will therefore be—

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			£	£
1952 Dec. 31	Cash . . . . *Dr.*		13,500	
	To Investment in Sub, Ltd.			10,125
	,, Dividends Receivable . . . . [$\frac{2}{3}$ × £5,062 10s.]			3,375

(2) BONUS DIVIDEND—

As to the bonus share dividend, the numerical holding is increased from 18,000 to 24,000 shares, but the true value of the equity remains unchanged. No journal entry is therefore required, the only entry in the books being in the nominal column of the Investment Account in respect of the additional shares. Even if all the bonus shares are sold, there will be no profit unless the net proceeds of the latter exceed one-quarter of the cost of the original holding after deduction of that part of the dividend which is a return of the outlay: that is, the bonus shares sold realize three-quarters of the original net cost per share. Thus, taking the entries made in (1*a*), the original net cost of the shares—18,000 at 45s. each—is £40,500 less the proportion of the dividend £6,300, making £34,200. On 18,000 shares this gives a net cost per share of 38s., but taking the bonus issue into account, on 24,000 shares, a net cost per share of 28s 6d., so that before any profit can be made the bonus shares must realize $\frac{3}{4}$ of the original net cost per share, i.e. $\frac{3}{4}$ of 38s. = 28s. 6d.

Illustration. K. Ltd. on 1st August, 19.., purchased 25,000 6 per cent Cumulative Preference Shares and 1,000 Ordinary Shares (all £1 each, fully paid) at 22s. and 60s. respectively in D. Ltd.

The Balance Sheet of D. Ltd. at 30th November, 19.., showed Profit and Loss Account in credit as follows—

	£
Profit brought forward	1,600
Profit for year	3,600

The issued share capital of D. Ltd. was 30,000 Preference and 2,000 Ordinary Shares.

At the annual general meeting the members approved the following recommendations of the Directors—

(1) Payment of two years' Preference Dividend to date.

(2) Payment of Ordinary Dividend of 75 per cent.

Draft Journal entries, ignoring narratives and taxation, to record the receipt of these dividends in the books of K. Ltd.

The position on 1st August, 19.. (acquisition date) is—

		Applicable to			
	Total	*Preference*			*Ordinary*
	£		£		£
Profit brought forward	1,600	Year's Dividend	1,800		
Proportion of profit for year accruing— $\frac{4}{12}$ of £3,600 . .	2,400	8 mths. Dividend	1,200	Balance	1,000
	£4,000		£3,000		£1,000
K. Ltd., proportion—					
Preference—$\frac{25}{30}$			£2,500		
Ordinary—$\frac{1}{2}$					£500

These last figures represent the capital proportion of the first dividends received by K. Ltd. from D. Ltd. and will therefore be credited to the Investment Account. The excess of the dividends received over these amounts will be credited to Dividends Receivable.

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		£	£
Cash (2 years' dividend on 25,000 Pref. Shares).	*Dr.*	3,000	
To D, Ltd. Preference Shares Investment .	.		2,500
„ Dividends Receivable.	.		500
Cash (75% on 1,000 Ordinary Shares) . .	*Dr.*	750	
To D, Ltd. Ordinary Shares Investment .	.		500
„ Dividends Receivable.	.		250

Note. This is the most prudent solution, but the alternative methods described in the previous illustration may be used.

Sometimes holding companies bring into their accounts all the profits or losses of their subsidiaries—although not legally compelled to do so, and, indeed, as mentioned, it is an unsound policy—treating the subsidiaries as debtors for profits and crediting a *separate* account called "Profits and Losses of Subsidiary Companies Account," or "Subsidiary Companies Revenue Account," losses being treated conversely. On the receipt of dividends by the Holding Company, cash will be debited and the Subsidiaries Profits Account credited.

Illustration. Sub, Ltd., in its first year loses £5,000; in its second year makes a profit of £12,000 and pays a dividend of £6,000. Show Journal entries, without narratives, in the books of the holding company, assuming that the latter company brings into account profits or losses of the subsidiary company; and that the whole of the share capital of Sub, Ltd., is held by the holding company.

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			£	£
Year 1	Profits and Losses of Subsidiary Companies . . . . . . *Dr.*		5,000	
	To Sub, Ltd., Profits Account .			5,000
2	Sub, Ltd., Profits Account . . *Dr.*		12,000	
	To Profits and Losses of Subsidiary Companies			12,000
	Cash . . . . *Dr.*		6,000	
	To Sub, Ltd., Profits Account .			6,000

The result is to show the Profits and Losses of Subsidiary Companies Account in credit for £7,000, £6,000 of which is received in cash, £1,000 being a debit balance on Sub, Ltd., Profits Account. The Profits and Losses of Subsidiary Companies Account is usually closed off to Profit and Loss Account.

Where, as is usual, there have been inter-company transactions, all UNREALIZED profits must be reserved for or eliminated. The most frequent example of this occurs where a subsidiary company sells goods to the holding company or to another subsidiary at a profit to itself. In the books of the selling company the profit on the sale will be brought into its accounts, thus showing a profit to the group as a whole, although the goods may not have been sold to outsiders. Hence the necessity for a reserve in respect of such unrealized profit. Obviously, if the buying company has sold all the goods no adjustment is entailed.

Group Accounts. It will be obvious that the entries outlined in the previous pages appearing in the final accounts—i.e. an Investment in Subsidiary Account at cost in the Balance Sheet and a credit to Profit and Loss Account in respect of dividends received —will give very inadequate information to the members of the Holding Company. For this reason, the submission of group accounts is made compulsory by the Companies Act, 1948. Thus, Section 150 of the Act states—

(1) Where at the end of its financial year a company has subsidiaries, accounts or statements (in this Act referred to as "group accounts") dealing as hereinafter mentioned with the state of affairs and profit or loss of the company, and the subsidiaries shall, subject to the next following subsection, be laid before the company in general meeting when the company's own Balance Sheet and Profit and Loss Account are so laid.

(2) Notwithstanding anything in the foregoing subsection—

(*a*) Group accounts shall not be required where the company is at the end of its financial year the wholly owned subsidiary of another body corporate incorporated in Great Britain; and

(*b*) Group accounts need not deal with a subsidiary of the company if the company's directors are of opinion that—

(i) It is impracticable, or would be of no real value to members of the company, in view of the insignificant amounts involved, or would involve expense or delay out of proportion to the value to members of the company; or

(ii) The result would be misleading, or harmful to the business of the company or any of its subsidiaries; or

(iii) The business of the holding company and that of the subsidiary are so different that they cannot reasonably be treated as a single undertaking;

and, if the directors are of such an opinion about each of the company's subsidiaries, group accounts shall not be required:

Provided that the approval of the Board of Trade shall be required for not dealing in group accounts with a subsidiary on the ground that the result would be harmful or on the ground of the difference between the business of the holding company and that of the subsidiary.

(4) For the purposes of this section a body corporate shall be deemed to be the wholly owned subsidiary of another if it has no members except that other and that other's wholly owned subsidiaries and its or their nominees.

Moreover, it is provided in Section 152 that—

(1) The group accounts laid before a company shall give a true and fair view of the state of affairs and profit or loss of the company and the subsidiaries dealt with thereby as a whole, so far as concerns members of the company.

(3) Without prejudice to subsection (1) of this section, the group accounts, if prepared as consolidated accounts, shall comply with the requirements of the Eighth Schedule to this Act, so far as applicable thereto, and if not so prepared shall give the same or equivalent information:

Provided that the Board of Trade may, on the application or with the consent of a company's directors, modify the said requirements in relation to that company for the purpose of adapting them to the circumstances of the company.

Form of the Group Accounts. Having laid down the information which is to be given, the Act allows some latitude to the Directors in deciding how the information should be presented to the members, the relative section is—

151.—(1) Subject to the next following subsection, the group accounts laid before a holding company shall be consolidated accounts comprising—

(a) A consolidated Balance Sheet dealing with the state of affairs of the company and all the subsidiaries to be dealt with in group accounts;

(b) A consolidated Profit and Loss Account dealing with the profit or loss of the company and those subsidiaries.

(2) If the company's directors are of opinion that it is better for the purpose—

(a) Of presenting the same or equivalent information about the state of affairs and profit or loss of the company and those subsidiaries; and

(b) Of so presenting it that it may be readily appreciated by the company's members;

the group accounts may be prepared in a form other than that required by the foregoing subsection, and in particular may consist of more than one set of consolidated accounts dealing respectively with the company and one group of subsidiaries and with other groups of subsidiaries, or of separate accounts dealing with each of the subsidiaries, or of statements expanding the information about the subsidiaries in the company's own accounts, or any combination of those forms.

(3) The group accounts may be wholly or partly incorporated in the company's own Balance Sheet and Profit and Loss Account.

In connection with the last subsection, the following subsection of Section 149 may be noted—

(5) Subsections (1) and (2) of this section [which require the Balance Sheet and Profit and Loss Account to give a true and fair view of the state of affairs and profit or loss respectively, and require compliance with the Eighth Schedule] shall not apply to a company's profit and loss account, if—

(a) The company has subsidiaries; and

(b) The profit and loss account is framed as a consolidated profit and loss account dealing with all or any of the company's subsidiaries as well as the company, and—

(i) Complies with the requirements of this Act relating to consolidated profit and loss accounts; and

(ii) Shows how much of the consolidated profit or loss for the financial year is dealt with in the accounts of the company.

Thus a consolidated Profit and Loss Account may be substituted for a separate Profit and Loss Account of the Holding Company.

Financial Year of the Group. Since group accounts have to be prepared, it is obviously preferable from the accountancy point of view that the financial years of all the companies in the group should coincide. From the directors' point of view, however, there may be good reasons against it, the most common probably being the increase of tax liabilities on an adjustment of the accounting period. Section 153 of the Act therefore provides—

(1) A holding company's directors shall secure that, except where in their opinion there are good reasons against it, the financial year of each of its subsidiaries shall coincide with the company's own financial year.

(2) Where it appears to the Board of Trade desirable for a holding company or a holding company's subsidiary to extend its financial year so that the subsidiary's financial year may end with that of the holding company, and for that purpose to postpone the submission of the relevant accounts to a general meeting from one calendar year to the next, the Board may on the application or with the consent of the directors of the company whose financial year is to be extended direct that, in the case of that company, the submission of accounts to a general meeting, the holding of an annual general meeting

or the making of an annual return shall not be required in the earlier of the said calendar years.

On the other hand, by Section 152 (2)—

Where the financial year of a subsidiary does not coincide with that of the holding company, the group accounts shall, unless the Board of Trade on the application or with the consent of the holding company's directors otherwise direct, deal with the subsidiary's state of affairs as at the end of its financial year ending with or last before that of the holding company, and with the subsidiary's profit or loss for that financial year.

The directors of the holding company, moreover, are required to annex to the accounts a statement showing—

(*a*) The reasons why they consider that the subsidiaries' financial years should not end with that of the holding company.

(*b*) The dates on which the subsidiaries' financial years ending last before that of the company respectively ended or the earliest and latest of those dates. (Eighth Schedule, Part II, paragraphs 15 (6) and 22.)

Accounts of the Holding Company. The provisions of Part I of the Eighth Schedule of the Companies Act, 1948, have been considered in the previous chapter. The following modifications of and additions to those requirements in respect of a company's own accounts are contained in Part II of the Schedule—

15.—(1) This paragraph shall apply where the company is a holding company, whether or not it is itself a subsidiary of another body corporate.

(2) The aggregate amount of assets consisting of shares in, or amounts owing (whether on account of a loan or otherwise) from, the company's subsidiaries, distinguishing shares from indebtedness, shall be set out in the Balance Sheet separately from all the other assets of the company, and the aggregate amount of indebtedness (whether on account of a loan or otherwise) to the company's subsidiaries shall be so set out separately from all its other liabilities and—

(*a*) The references in Part I of this Schedule to the company's investments shall not include investments in its subsidiaries required by this paragraph to be separately set out; and

(*b*) Paragraph 5, sub-paragraph (1) (*a*) of paragraph 12, and sub-paragraph (2) of paragraph 14 of this Schedule shall not apply in relation to fixed assets consisting of interests in the company's subsidiaries.

(3) There shall be shown by way of note on the Balance Sheet or in a statement or report annexed thereto the number, description and amount of the shares in and debentures of the company held by its subsidiaries or their nominees, but excluding any of those shares or debentures in the case of which the subsidiary is concerned as personal representative or in the case of which it is concerned as trustee and neither the company nor any subsidiary thereof is beneficially interested under the trust, otherwise than by way of security only for the purposes of a transaction entered into by it in the ordinary course of a business which includes the lending of money.

(4) Where group accounts are not submitted, there shall be annexed to the Balance Sheet a statement showing—

(*a*) The reasons why subsidiaries are not dealt with in group accounts;

(*b*) The net aggregate amount, so far as it concerns members of the holding company and is not dealt with in the company's accounts, of the subsidiaries' profits after deducting the subsidiaries' losses (or vice versa)—

(i) For the respective financial years of the subsidiaries ending with or during the financial year of the company; and

(ii) For their previous financial years since they respectively became the holding company's subsidiary;

(c) The net aggregate amount of the subsidiaries' profits after deducting the subsidiaries' losses (or vice versa)—

(i) For the respective financial years of the subsidiaries ending with or during the financial year of the company; and

(ii) For their other financial years since they respectively became the holding company's subsidiary;

so far as those profits are dealt with, or provision is made for those losses, in the company's accounts;

(d) Any qualifications contained in the report of the auditors of the subsidiaries on their accounts for their respective financial years ending as aforesaid, and any note or saving contained in those accounts to call attention to a matter which, apart from the note or saving, would properly have been referred to in such a qualification, in so far as the matter which is the subject of the qualification or note is not covered by the company's own accounts and is material from the point of view of its members;

or, in so far as the information required by this sub-paragraph is not obtainable, a statement that it is not obtainable:

Provided that the Board of Trade may, on the application or with the consent of the company's directors, direct that in relation to any subsidiary this sub-paragraph shall not apply or shall apply only to such extent as may be provided by the direction.

(5) Paragraphs (b) and (c) of the last foregoing sub-paragraph shall apply only to profits and losses of a subsidiary which may properly be treated in the holding company's accounts as revenue profits or losses, and the profits or losses attributable to any shares in a subsidiary for the time being held by the holding company or any other of its subsidiaries shall not (for that or any other purpose) be treated as aforesaid so far as they are profits or losses for the period before the date on or as from which the shares were acquired by the company or any of its subsidiaries, except that they may in a proper case be so treated where—

(a) The company is itself the subsidiary of another body corporate; and

(b) The shares were acquired from that body corporate or a subsidiary of it;

and for the purpose of determining whether any profits or losses are to be treated as profits or losses for the said period the profit or loss for any financial year of the subsidiary may, if it is not practicable to apportion it with reasonable accuracy by reference to the facts, be treated as accruing from day to day during that year and be apportioned accordingly.

(6) Where group accounts are not submitted there shall be annexed to the Balance Sheet a statement showing, in relation to the subsidiaries (if any) whose financial years did not end with that of the company—

(a) The reasons why the company's directors consider that the subsidiaries' financial years should not end with that of the company; and

(b) The dates on which the subsidiaries' financial years ending last before that of the company respectively ended or the earliest and latest of those dates.

16.—(1) The Balance Sheet of a company which is a subsidiary of another body corporate, whether or not it is itself a holding company, shall show the aggregate amount of its indebtedness to all bodies corporate of which it is a subsidiary or a fellow subsidiary and the aggregate amount of the indebtedness of all such bodies corporate to it, distinguishing in each case between indebtedness in respect of debentures and otherwise.

(2) For the purposes of this paragraph, a company shall be deemed to be a fellow subsidiary of another body corporate if both are subsidiaries of the same body corporate but neither is the other's.

Consolidated Accounts. The remaining sections of Part II of the Eighth Schedule deal with the consolidated accounts of a holding company and its subsidiaries as follows—

17. Subject to the following paragraphs of this Part of this Schedule, the consolidated Balance Sheet and Profit and Loss Account shall combine the information contained in the separate balance sheets and profit and loss accounts of the holding company and of the subsidiaries dealt with by the consolidated accounts, but with such adjustments (if any) as the directors of the holding company think necessary.

18. Subject as aforesaid and to Part III of this Schedule [which contains exceptions for certain classes of company, e.g. banking, discount and assurance companies] the consolidated accounts shall, in giving the said information, comply, so far as practicable, with the requirements of this Act as if they were the accounts of an actual company.

19. Sections one hundred and ninety-six and one hundred and ninety-seven of this Act [which contain provisions for the disclosure of loans to and remuneration, etc., of directors] shall not, by virtue of the two last foregoing paragraphs, apply for the purpose of the consolidated accounts.[1]

20. Paragraph 7 of this Schedule [which requires disclosure in respect of increases and decreases in reserves and provisions] shall not apply for the purpose of any consolidated accounts laid before a company with the first Balance Sheet so laid after the coming into force of this Act.

21. In relation to any subsidiaries of the holding company *not* dealt with by the consolidated accounts—

(*a*) Sub-paragraphs (2) and (3) of paragraph 15 of this Schedule [concerning the separate statement of assets consisting of shares, etc., in subsidiaries and a statement of shares and debentures held by subsidiaries] shall apply for the purpose of those accounts as if those accounts were the accounts of an actual company of which they were subsidiaries; and

(*b*) There shall be annexed the like statement as is required by sub-paragraph (4) of that paragraph where there are no group accounts (see page 1045), but as if references therein to the holding company's accounts were references to the consolidated accounts.

22. In relation to any subsidiaries (whether or not dealt with by the consolidated accounts), whose financial years did not end with that of the company, there shall be annexed the like statement as is required by sub-paragraph (6) of paragraph 15 of this Schedule where there are no group accounts (see page 1046).

Miscellaneous. Extracts from the 1948 Act to be noted—

Section 156. The Profit and Loss Account and, so far as not incorporated in the Balance Sheet or Profit and Loss Account, any group accounts laid before the company in general meeting shall be annexed to the Balance Sheet and approved by the board of directors before the Balance Sheet is signed on their behalf, and the Auditors' Report shall be attached thereto.

Ninth Schedule, paragraph 4: [The auditors shall state in their report]—

In the case of a holding company submitting group accounts whether, in their opinion, the group accounts have been properly prepared in accordance with the provisions of this Act so as to give a true and fair view of the state of affairs and profit or loss of the company and its subsidiaries dealt with thereby, so far as concerns members of the company, or, as the case may be, so as to give a true and fair view thereof subject to the non-disclosure of any matters (to be indicated in the report) which by virtue of Part III of the Eighth Schedule to this Act are not required to be disclosed.

Eighth Schedule, Part III, paragraph 26 [which states exceptions for special classes of company]—

Where a company entitled to the benefit of any provision contained in this

[1] See footnote to page 797.

Part of this Schedule is a holding company, the reference in Part II of this Schedule to consolidated accounts complying with the requirements of this Act shall, in relation to consolidated accounts of that company, be construed as referring to those requirements in so far only as they apply to the separate accounts of that company.

Summary. It has been deemed necessary to give the provisions of the Companies Act, 1948, in detail. To assist the student, however, the following summary of the main points is given—

(1) Group Accounts in one form or another must be submitted to the members of the holding company.

(2) Such accounts must deal with and give a true and fair view of the state of affairs and profit or loss of the group as a whole, as far as concerns members of the holding company.

(3) Primarily the group accounts should consist of a Consolidated Balance Sheet and Consolidated Profit and Loss Account combining the information contained in the separate balance sheets and profit and loss accounts of the constituent companies, with such adjustments (if any) as the directors of the holding company think necessary.

(4) If, however, the directors consider that the same or equivalent information would be better presented or more readily appreciated by the members of the company in another form, they may do so, and in particular they may present—

(*a*) Consolidated accounts dealing with

(i) the company and one group of subsidiaries,

(ii) other groups of subsidiaries.

(*b*) Separate accounts dealing with each of the subsidiaries.

(*c*) Statements expanding the information about the subsidiaries in the company's own accounts.

(*d*) Any combination of these forms.

In addition group accounts may be wholly or partly incorporated in the company's own Balance Sheet and Profit and Loss Account.

(5) Consolidated accounts must comply with the provisions of the Companies Act as if they were the accounts of an actual company. Group accounts, if not prepared as consolidated accounts, must nevertheless give the same or equivalent information.

(6) Group accounts are not required when the holding company is itself the wholly owned subsidiary of another body corporate incorporated in Great Britain.

(7) A subsidiary may be excluded from group accounts in certain circumstances (Companies Act, 1948, Sect. 150 (2*b*)). When any of the subsidiaries are so excluded, or when no group accounts are presented, the directors are required to annex to the holding company's accounts—

(*a*) A statement giving the reasons for the exclusion.

(*b*) Certain information detailed in paragraph 15 (4) of Part II, Eighth Schedule.

(8) Unless the directors consider that there are good reasons against it, the financial year of each subsidiary must coincide with that of the holding company. Where it does not, the financial year of the subsidiary to be taken is stated in Section 152 (2). Also the directors must give their reasons and certain information (Eighth Schedule, Part II, paragraphs 15 (6) and 22).

Despite the alternative methods already described, it will probably be found in the majority of cases that the best way of presenting group accounts is in the form of a Consolidated Balance Sheet and a Consolidated Profit and Loss Account. The preparation of these accounts will therefore be described in detail. It may be noted that, whilst the principles are comparatively easy to understand, many difficult and complicated problems are bound to arise in practice which will only be solved in the light of experience.

PREPARATION OF THE CONSOLIDATED BALANCE SHEET

The holding company and its subsidiaries are considered as a whole economic unit, all the assets and liabilities of the various companies being aggregated. The Consolidated Balance Sheet must be compiled as if it were the Balance Sheet of an actual company and therefore, as regards the published result, many of the provisions of the Companies Act will apply as if it were a single Balance Sheet.

The consolidated accounts may be compared with those of a concern having a head office and several branches as described in an earlier chapter and to a certain extent the same principles will apply, although the analogy cannot be pressed too far. The basic principle underlying the preparation of the Consolidated Balance Sheet is that all "internal" items or inter-company balances (appearing of course on opposite sides of the respective Balance Sheets) must be eliminated, the result showing the assets and liabilities of the group as a whole in relation to the outside world. The simplest example of this is in respect of the holding of shares in a subsidiary (hereinafter referred to as S) by the holding company (H), the item appearing on the assets side of H and, as share capital, on the liabilities side of S, thus—

Illustration. H acquired all the shares of S on 30th June, 19.., for £2,000. From the following skeleton Balance Sheets prepare the Consolidated Balance Sheet at 30th June, 19...

BALANCE SHEETS AS AT 30TH JUNE, 19..

	H	S		H	S
	£	£		£	£
Share Capital—			Sundry Assets . .	6,500	2,500
£1 fully paid. .	5,000	2,000	Shares in S at cost .	2,000	
Profit and Loss Account . . .	1,500	—			
Creditors. . .	2,000	500			
	£8,500	£2,500		£8,500	£2,500

CONSOLIDATED BALANCE SHEET

	£		£
Share Capital	5,000	Sundry Assets	
Profit and Loss Account	1,500	[£6,500 + £2,500]	9,000
Creditors [£2,000 + £500]	2,500		
	£9,000		£9,000

The items in heavy print, being internals, are eliminated, the remainder being aggregated, or, in other words, the item "Shares in S" is eliminated from the assets side of the H Balance Sheet and the assets and liabilities of S, which it represents, are substituted.

Pre-acquisition Profits and Losses. It will be noticed that in the illustration above, the Profit and Loss Account of S is shown as nil, for the sake of simplicity. This will rarely be the case in practice, as there will usually be undistributed profits (or losses) at the date of acquisition of shares, reflected in reserves and in the balance of Profit and Loss Account and in an increase in the net assets of the company. As was stated in the early part of this chapter, such profits must be regarded as capital by the holding company since they will be taken into account in fixing the purchase price. Thus, in the Consolidated Balance Sheet preparation, all reserves and profits (or losses) existing at the date of acquisition must be set off against the purchase price of the shares and will consequently not appear in the Balance Sheet itself. There may be difficulty in some cases in deciding whether an item is actually a reserve or not. A typical case arises in respect of Income Tax where provision is made in the accounts based on the profits to the date of the accounts. Since there is no legal liability on such profits at that date (the assessment being based on the profits of the preceding year in normal circumstances) it is often argued that the item is a reserve and not a provision —the difference in the matter under review being that the former will be taken into account along with pre-acquisition profits, the latter will be included in liabilities. On the other hand, the opinion is advanced that the amount is set aside to meet a "deferred" or contingent liability and therefore the proper classification is as a provision. No definite answer to this question has yet been given.

Illustration. Assuming the same facts as in the previous illustration, except that the shares cost £2,300, the Sundry Assets of H and S being £6,200 and £2,800 respectively, and £200 and £100 standing to the credit of the Profit and Loss Account and Reserve respectively of S, show the Consolidated Balance Sheet.

CONSOLIDATED BALANCE SHEET

	H	S	Adjustments	Total		H	S	Adjustments	Tot
	£	£	£	£		£	£	£	£
hare Capital	5,000	**2,000**	− 2,000	5,000	Sundry Assets	6,200	2,800		9,0
eserve		**100**	− 100		Shares in S at cost.	**2,300**		− 2,300	
rofit and Loss	1,500	**200**	− 200	1,500					
reditors	2,000	500		2,500					
	£8,500	£2,800	−£2,300	£9,000		£8,500	£2,800	−£2,300	£9,0

Illustration. Assuming the same facts as above, except that the Share Capital of S (all acquired) was £2,600, the Profit and Loss Account of S being £300 in debit and the Reserve nil, show the Consolidated Balance Sheet.

CONSOLIDATED BALANCE SHEET

	H	S	Adjustments	Total		H	S	Adjustments	Total
	£	£	£	£		£	£	£	£
hare Capital .	5,000	2,600	− 2,600	5,000	Sundry Assets .	6,200	2,800		9,000
rofit and Loss .	1,500			1,500	Shares in S .	2,300		− 2,300	
reditors .	2,000	500		2,500	Profit and Loss .		300	− 300	
	£8,500	£3,100	−£2,600	£9,000		£8,500	£3,100	−£2,600	£9,000

Equity. The net worth of a concern is sometimes referred to as the equity of the concern. The equity can be calculated either by taking the net assets or by taking share capital, reserves and profit and loss balance. Thus the equity of S (above) is £2,300—net assets (£2,800 less £500) or capital less loss (£2,600 less £300).

Goodwill or Cost of Control. In all the illustrations so far the cost of the shares in S has been equal to the equity, so that a straight elimination has been possible in preparing the Consolidated Balance Sheet. It often happens, however, that the cost of the shares differs from the equity of S. If the cost is greater, this is, in the absence of other information, taken as indicating the unrecorded or undervalued goodwill of S. Such excess will therefore appear in the Consolidated Balance Sheet as Goodwill or Cost of Control.[1]

Illustration. H acquired all the shares of S on 30th June, 19.., for £2,600, the Balance Sheets being as follows. Show the Consolidated Balance Sheet.

BALANCE SHEETS AS AT 30TH JUNE, 19..

	H	S		H	S
	£	£		£	£
Share Capital . .	5,000	2,000	Sundry Assets . .	5,900	2,800
Profit and Loss .	1,500	300	Shares in S . .	2,600	
Creditors . .	2,000	500			
	£8,500	£2,800		£8,500	£2,800

CONSOLIDATED BALANCE SHEET

	H	S	Adjustments	Total		H	S	Adjustments	Total
	£	£	£	£		£	£	£	£
Share Capital .	5,000	2,000	− 2,000	5,000	Sundry Assets .	5,900	2,800		8,700
Profit and Loss .	1,500	300	− 300	1,500	Shares in S .	2,600		− 2,600	
Creditors .	2,000	500		2 500	Goodwill .			+ 300	300
	£8,500	£2,800	−£2,300	£9,000		£8,500	£2,800	−£2,300	£9,000

[1] Other terms are in use, e.g. Excess of Cost of Shares over Par Value and Accumulated Profit and Reserves at date of acquisition.

Since there are only £2,000 Share Capital and £300 pre-acquisition profits to set off against the purchase price of £2,600, the remaining £300 is carried out into the Consolidated Balance Sheet as Goodwill.

Where, on the other hand, the purchase price of the shares is *less* than the equity of S, this is in normal circumstances taken as indicative of negative goodwill (i.e. "Badwill") and the difference will appear on the liabilities side of the Consolidated Balance Sheet as Capital Reserve.

Illustration. Assuming the same facts as above, except that the cost of the shares was £2,200, Sundry Assets of H being £6,300, show the Consolidated Balance Sheet.

CONSOLIDATED BALANCE SHEET

	H	S	Adjustments	Total		H	S	Adjustments	Total
	£	£	£	£		£	£	£	£
Share Capital	5,000	2,000	− 2,000	5,000	Sundry Assets	6,300	2,800		9,100
Profit and Loss	1,500	300	− 300	1,500	Shares in S	2,200		− 2,200	
Creditors	2,000	500		2,500					
Capital Reserve			+ 100	100					
	£8,500	£2,800	−£2,200	£9,100		£8,500	£2,800	−£2,200	£9,100

The goodwill already appearing in the individual Balance Sheets of the constituent companies will remain unaffected by the adjustments and will appear in aggregate in the Consolidated Balance Sheet, unless it is considered advisable to utilize the whole or part of the Capital Reserve in extinguishing or reducing it. (But in examination work this should not be done unless clearly instructed or special circumstances warrant it.)

Further consideration of what has so far been called Goodwill will show that the excess of the purchase price over the net assets acquired may in fact be apportioned between—

(1) Unrecorded or undervalued goodwill, and

(2) Cost of control,

for the price paid for all or the majority of the shares in a company carrying with them control of the company will usually be greater than that for a small number of shares carrying no power of control. No attempt is often made to differentiate between the two, the excess being shown as Goodwill and/or Cost of Control. If the premium paid is the measurement of the true goodwill based on super-profits, it can properly be described as such, but, where—

(*a*) There are no super-profits, or

(*b*) The premium exceeds that based thereon,

it is strictly cost of control. This "excess" premium may be well worth while because of—

(1) The resultant economies,

(2) The elimination of competition, and

(3) The prevention of acquisition of control by rivals.

Therefore, the distinction must be based upon the facts of the case and, if the profit level is such as to justify the premium paid for the shares, the proper description is goodwill, otherwise it is cost of control (see note on page 1051).

In addition it must be remembered that the excess cost may be reflected in an undervaluation of assets other than goodwill or in an overstatement of liabilities. In order to show a true and fair view of the state of affairs in the Consolidated Balance Sheet, the correct treatment in this case is to adjust the assets and/or liabilities concerned to their correct value when preparing the Balance Sheet.

The converse position where the cost of the shares is less than their apparent value, which has so far been described as Capital Reserve, may on further consideration of the facts be due to—

(1) Over-valuation of assets and/or understatement of liabilities. The book value will be adjusted in the Consolidated Balance Sheet, thus reducing the Capital Reserve.

(2) The company in which the shares are acquired earning profits less than those normally expected from that type of business. There is thus an element of negative goodwill which will be put to Capital Reserve, which, as described above, may be wholly or partly set off against goodwill.

(3) A share exchange, the cost of the shares in S being shown at the nominal value of the shares in H exchanged therefor, which is less than the actual value (H gives (say) shares of 10s. worth 18s. for shares in S worth 12s.) the investment in S being shown at cost based on the nominal (10s. value). In the Consolidated Balance Sheet the difference will be shown as Capital Reserve. In the books of H the correct treatment is to raise a Share Premium Account with the excess of the market over the nominal value of the shares, the investment in S being increased accordingly.

(4) The shares in S being acquired cheaply through special circumstances, e.g. slump conditions, forced selling, temporary difficulties of S. Thus the £1 shares of S may be bought for say 15s. while they are worth 17s. on book values. If it is decided that the latter are over-valued, or that there is an element of "badwill," adjustments will be required as in (1) and (2) above respectively; otherwise, in contrast to (3), there is an apparent profit on acquisition, but the prudent course would be to put this to Capital Reserve.

Where, as will be considered in greater detail later, H does not acquire all the shares in S, but say 75 per cent thereof, it will be clear that the goodwill figure described above will represent a proportion only of the total goodwill of S, the remainder attaching to the other 25 per cent of the shares held by the Minority Shareholders. The question therefore arises whether, in the Consolidated Balance Sheet, the goodwill should be written up to its true figure by adding to the (in this case) three-quarters interest of H, the one-quarter interest of the Minority Shareholders, a corresponding entry being made on the liabilities side of the Consolidated Balance Sheet to

show this latter one-quarter interest. It is contended that since all the other assets are shown in the Consolidated Balance Sheet in full and not merely to the extent of H's proportion, it is only logical to deal similarly with goodwill. The better practice, however, is not to do this, since goodwill should be shown at cost and not at an inflated figure. It should be noted that this question applies only to Goodwill proper and not to Cost of Control, the latter obviously attaching entirely to the large bulk of shares which carry with them the power of control, and in no respect to the small minority interest.

In dealing with Goodwill and Capital Reserve in advanced problems it may be necessary to prepare two schedules—

(1) Dealing with the difference between the cost of shares and the par value, and

(2) Dealing with the pre-acquisition profits and losses.

Alternatively the schedules may be—

(*a*) Dealing with losses prior to acquisition and excess of cost of shares over par value, and

(*b*) Dealing with profits prior to acquisition and excess of par value of shares over cost.

Illustration. H acquires 60,000 shares in S at a cost of £50,000 and 30,000 shares in R at a cost of £55,000, the pre-acquisition loss of S being £6,000 and the pre-acquisition profit of R being £10,000. All the shares are fully paid £1 shares. There is no minority interest.

The two schedules are—

(1) GOODWILL (or Cost of Control)

	S	R	Total
	£	£	£
Cost of Acquisition	50,000	55,000	105,000
Par Value	60,000	30,000	90,000
	−£10,000	+£25,000	+£15,000

(2) CAPITAL RESERVE

	S	R	Total
	£	£	£
Pre-acquisition Profit		10,000	10,000
Pre-acquisition Loss	−6,000		−6,000
			£4,000

There is thus a debit on Goodwill of £15,000 and a credit on Capital Reserve of £4,000; the latter would normally be set off against the former, leaving a net balance of Goodwill of £11,000.

The main disadvantage of this arrangement is that there may be both debit and credit items in each schedule, whereas, as will be seen in the alternative method, this likely confusion is avoided; thus—

(a) (Debit) GOODWILL (or Cost of Control)

	S	R	Total
	£	£	£
Cost of Acquisition		55,000	
Par Value.		30,000	
Pre-acquisition Loss . . .	6,000		
	£6,000	£25,000	£31,000

(b) (Credit) CAPITAL RESERVE

	S	R	Total
	£	£	£
Par Value.	60,000		
Cost of Acquisition . . .	50,000		
Pre-acquisition Profit. . .		10,000	
	£10,000	£10,000	£20,000

The credit of £20,000 is set off against the debit of £31,000 leaving a net debit of Goodwill of £11,000. This method not only avoids plus and minus signs but also it avoids a credit appearing in Goodwill and a debit in Capital Reserve (see items in previous illustration of —£10,000 in Goodwill and —£6,000 in Capital Reserve).

Inter-company Balances. The fact that all internal items or inter-company balances must be eliminated in the preparation of the Consolidated Balance Sheet has already been stated. These will include—

(1) Share Capital—the elimination of the share capital of S against H's investment in S has already been shown. Conversely, as will be described in greater detail later, any shares in H held by S must also be eliminated against the share capital of H, which of course appears in the Consolidated Balance Sheet as the share capital of the group.

(2) Debentures of one company held by another.

(3) Loans to one company by another.

(4) Current Accounts.

These adjustments present no difficulty, it merely being a question of setting off an asset in one Balance Sheet against a liability in another. Thus, if on the liabilities side of H's Balance Sheet appears Debentures £10,000 and the assets side of S's Balance Sheet shows that S holds £3,000 thereof, the net figure in the Consolidated Balance Sheet will be Debentures £7,000. Again, if Sundry Debtors of H include S £400, then Sundry Creditors of S must include H £400; the £400's will be eliminated and only the outside debtors and creditors shown in the Consolidated Balance Sheet.

Contingent Liabilities. In their own balance sheets the constituent companies will show contingent liabilities in the normal way by means of a note. When preparing the Consolidated Balance Sheet, such liabilities must be divided into (i) internal and (ii) external. The latter will continue in the Consolidated Balance Sheet as notes,

but the former will usually appear in the Consolidated Balance Sheet itself as actual liabilities, so that a note is unnecessary.

The two most common items of this type are—

(1) Bills of Exchange—where, for instance, S has issued bills to H which has discounted them. S will show Bills Payable amongst its liabilities and there will be a note to H's Balance Sheet in respect of the contingent liability on bills discounted. In the Consolidated Balance Sheet, Bills Payable will appear as a liability of the group.

Illustration. The Balance Sheet of S shows Bills Payable of £6,000. All these were issued to H, in whose Balance Sheet appear the following—

Bills Receivable (from S), £2,000.

Note. There is a contingent liability on Bills discounted of £9,000 (£4,000 of which are from S).

How would these items appear in the Consolidated Balance Sheet?

The £2,000 of S's bills held by H will be set off against Bills Payable £6,000 (being internal transactions), the remaining £4,000 being shown in the Consolidated Balance Sheet as a liability. There will be a note to the Consolidated Balance Sheet in respect of H's contingent liability on bills discounted of £5,000 (i.e. excluding S's bills discounted which appear as an actual liability).

(2) Guarantees by one company in the group in respect of another—where for instance H guarantees certain liabilities of S. As in (1), these will appear in the Consolidated Balance Sheet as actual liabilities of the group, so that a note is unnecessary.

Minority Interest. In all the illustrations so far, H has acquired all the shares in S, i.e. H has had a 100 per cent holding and the question of a minority interest does not therefore arise. It may be objected on purely technical grounds that H, being a separate legal person (but only ONE) cannot constitute (no more than an individual can) the sole shareholder of S. This situation is however met by H holding all the shares in S except one which is allotted to a nominee (usually a director) of H. If, however, H (directly or through nominee(s)) has less than a 100 per cent holding in S, say 80 per cent, there will be a minority interest in respect of the remaining (20 per cent) issued share capital held by shareholders outside the group. In the preparation of the Consolidated Balance Sheet the principles already outlined will again be followed. All the assets and liabilities of the constituent companies will be aggregated, but the minority shareholders must be shown as Creditors on the liabilities side in respect of their interest. The latter will consist of their share of (*a*) Share Capital, (*b*) Reserves, and (*c*) Profit and Loss balance (the total of these being equal to the net assets). Obviously, in making the necessary adjustments for the Consolidated Balance Sheet in respect of H's holding, only its due proportion of profits, etc., (e.g. 80 per cent) will be taken into account. As far as the

minority shareholders are concerned, there will be no need to make the sharp contrast between pre- and post-acquisition profits required in respect of H's holding, their interest not being affected thereby.

Illustration. H acquired 80 per cent of the shares of S on 30th June, 19.., for £2,700, when the profit and loss of the latter was in credit for £800. From the following Balance Sheets prepare the Consolidated Balance Sheet.

BALANCE SHEETS AS AT 30TH JUNE, 19..

	H	S		H	S
	£	£		£	£
Share Capital— £1 fully paid . .	3,000	2,000	Sundry Assets . .	2,000	2,600
Profit and Loss . .	1,000	800	Debtors . . .	1,300	900
Creditors . . .	1,500	1,200	Bills Receivable . .		500
Bills Payable (in favour of S) . . .	500		Shares in S . . .	2,700	
	£6,000	£4,000		£6,000	£4,000

CONSOLIDATED BALANCE SHEET

	H	S	Adjustments	Total		H	S	Adjustments	Total
	£	£	£	£		£	£	£	£
Share Capital .	3,000	2,000	− 1,600 − 400	3,000	Sundry Assets . Debtors . .	2,000 1,300	2,600 900		4,600 2,200
Profit and Loss .	1,000	800	− 640 − 160	1,000	Bills Receivable		500	− 500	
Creditors . .	1,500	1,200		2,700	Shares in S .	2,700		− 1,600 − 640 − 460	
Bills Payable .	500		− 500						
Minority Interest			+ 400 + 160	560[1]	Goodwill (or Cost of Control) . .			+ 460	460[2]
	£6,000	£4,000	−£2,740	£7,260		£6,000	£4,000	−£2,740	£7,260

An objection is sometimes raised against this method of preparing a Consolidated Balance Sheet where the holding of H is less than 100 per cent on the grounds that the assets and liabilities of S appear in full in the Consolidated Balance Sheet although H (or the group) has not a 100 per cent share therein. Nevertheless, H does control them and it is usually considered that they are best shown as group figures with the minority interest shown separately. The alternative would be to take H's proportion of each asset and liability only, so that no entry for minority interest would be required, but it is rarely used in practice.

[1] The Minority Interest is—
20% of Share Capital (£2,000) plus Profit and Loss (£800), i.e. £2,800 = £560

[2] The Goodwill (or Cost of Control) is proved as follows—

	£	£
Cost of 1,600 Shares		2,700
Less Share Capital (80% of £2,000)	1,600	
Profit and Loss (80% of £800)	640	
		2,240
		£ 460

Illustration. H owns 4,000 shares in A, 3,000 shares in B, and B owns 5,000 shares in A. The issued share capitals of A and B (both subsidiaries of H) are £10,000 and £5,000 respectively, all in £1 shares fully paid. There are no Preference Shares.

The profits of A and B for the year ended 31st December, 19. ., are £1,500 and £2,000 respectively. Show the amounts attributable to Minority Interests, ignoring Taxation.

	£	£
Minority Interest in the profit of—		
A: 10 per cent of £1,500		150
B: 40 per cent of £2,000	800	
20 per cent of £1,500 (see below) . .	300	
		1,100

Thus, Minority Shareholders own 40 per cent of B's profit and 30 per cent of A's profit.

The Minority Interest of B is 40 per cent, but as B has a 50 per cent interest in A, the Minority Interest of the former company must (indirectly) therefore be 40 per cent of the share of profit B will get from A, i.e. 50 per cent; therefore, the proportion of profit attributable to the Minority Interest of B as regards A's profit is 40 per cent of 50 per cent, i.e. 20 per cent.

This can be seen clearly if it is assumed that the profit of A is fully distributed, thus—

Holder	Shares	Profit	Holder	Shares	Profit
		£			£
H	4,000	600	H . . .	3,000	1,650
B	5,000	750			
Minority . . .	1,000	150	Minority . .	2,000	1,100 (See above)
		1,500			
Less to B . .		750			
	10,000	£750		5,000	£2,750[1]

Illustration. From the following details, prepare schedule showing Minority Interests to be brought into the Consolidated Balance Sheet. All shares are £1 each, fully paid.

No entries have been made in the books of any of the companies for proportion of profit or dividend attributable to them from their holdings in the other companies. Ignore taxation.

[1] Profit £2,000, plus dividend from A of £750, equals £2,750.

	Subsidiary A	Subsidiary B
	£	£
Ordinary Shares	8,000	5,000
5% Preference Shares	3,000	—
Ordinary Shares in Subsidiaries held by—		
H	4,800	3,000
B	1,200	—
Outsiders	2,000	2,000
Preference Shares held by—		
H	1,500	—
B	500	—
Outsiders	1,000	—
The profits are	1,600	*Loss 900*

Show the Minority Interests, bringing into account the current year's arrear of Cumulative Preference Dividend.

		£			Minority Interest £
Preference Dividend—					
Outsiders	1,000 at 5%	50			50
H	1,500 at 5%	75			
B (see below)	500 at 5%	25			
		£150			
Profits—					
A: Profit		1,600			
Less Preference Dividend		150	Minority Interest, 25%	£362½	
		£1,450	Interest in A of Minority Shareholders of B—40% of 15% equals 6%[1]	87	449½
B: *Loss*		*900*			
Less Preference Dividend (see above)		25			
		£875	Minority Interest, 40%		*350*

It would not be correct to show the Minority Interests as a net figure of £149½; each heading should be shown, particularly as the item of £350 does not represent anything more than what is analogous to a contingent asset.

As, in fact, A has Minority Shareholders of 25 per cent only, it would seem a better way to show, as an offset, the item of £87 against the loss of £350, because it is, in fact, the Minority Interest of B (as regards B's share of A's profit). Thus—

	£		£
A: Profit (as shown above)	1,450	Minority Interest—25% of £1,450	362½
of which 15% is attributable to B	217½		
	£1,232½		
B: *Loss* (*as shown above*)	*875*		
Less Share of A's Profit	217½		
	£657½	Minority Interest—40% of *£657½*	*263*

[1] As B owns 1,200 shares in A, it is entitled to 15 per cent (£$\frac{1,200}{8,000}$) of £1,450, but the Minority Shareholders have 40 per cent interest in B, hence their proportion of A's profit is 40 per cent of 15 per cent of £1,450.

Although the former method is usually employed, the latter method, which is theoretically correct, should be mentioned in any examination problem relating to the above subject-matter.

Thus, it can be seen that the effect is to show figures of £362½ and *£263* instead of £449½ and *£350*.

Post-acquisition Profits and Losses. So far the Consolidated Balance Sheet has been prepared at the date of acquisition of shares in S, so that all reserves and profit and loss balance of S relate to the pre-acquisition period. Such reserves and profit or loss balance are, in the preparation of the Consolidated Balance Sheet, divided into (*a*) H's proportion, which having been adjusted against the cost of the shares in S, appears in the Consolidated Balance Sheet either in the Capital Reserve or Goodwill figure, and (*b*) minority shareholders' proportion which in the Consolidated Balance Sheet is added to the minority interest. Post-acquisition profits (*or losses*) and increases (*or decreases*) in reserves must similarly be split between H and minority shareholders; but while the latter are added to (*or deducted from*) the minority interest as above, the former will appear in the Consolidated Balance Sheet in the actual profit and loss or reserve figure. Thus, where the balance sheets are given at some date after the date of acquisition, it will be necessary, as far as H's proportion is concerned, to apportion reserves and profit and loss between the pre- and post-acquisition periods.

The rule whereby the pre-acquisition profit of a subsidiary attributable to a holding company must be considered as capital, not only conforms to sound accounting practice, but is afforded recognition by the Companies Act, 1948. So far, however, as concerns the Minority Shareholders of a subsidiary, it is immaterial whether or not their proportion of the profit has been earned before or after the date of the acquisition of the shares in the subsidiary by the holding company.

Illustration. Assuming the same facts as in the illustration on page 1057, except that the date of acquisition of the shares was one year before the date of the Balance Sheets and at that date the credit balance of profit and loss of S was £600, £200 having been earned since, show Consolidated Balance Sheet.

CONSOLIDATED BALANCE SHEET

	H	S	Adjustments	Total		H	S	Adjustments	Total
	£	£	£	£		£	£	£	£
Share Capital	3,000	2,000	− 1,600	3,000	Sundry Assets	2,000	2,600		4,600
			− 400		Debtors	1,300	900		2,200
Profit and Loss	1,000	800	− 480	1,160	Bills Receivable		500	− 500	
			− 160		Shares in S	2,700		− 1,600	
Creditors	1,500	1,200		2,700				− 480	
Bills Payable	500		− 500					− 620	
Minority Interest			+ 400	560[1]	Goodwill (or Cost				
			+ 160		of Control)			+ 620	620[2]
	£6,000	£4,000	−£2,580	£7,420		£6,000	£4,000	−£2,580	£7,420

(For [1] and [2] see footnotes on page 1061.)

Where the shares are acquired during the financial year of S and no accounts are drawn up to that date, the current year's profit must be apportioned, in the absence of other information, on a time basis.

Illustration. Had the shares been acquired in the previous illustration on the 1st January, 19.., the profit of £200 of S for the year to 30th June, 19.. would, in the absence of other data, be split as to £100 pre- and £100 post-acquisition. Thus, 80 per cent of £700, i.e. £560, would be adjusted against the cost of shares in S, 80 per cent of £100, i.e. £80, would be left in Profit and Loss, making with H's £1,000 a total of £1,080, and 20 per cent of £800, i.e. £160, would be added to minority interest as before.

Inter-company Unrealized Profit. When, for instance, S sells goods to H at a profit, such profit has been earned from the point of view of S and will accordingly be reflected in its Balance Sheet. From the point of view of the group, however, the profit has not been earned until the goods have been resold by H to the outside world. To the extent, therefore, that any of the goods have not been so resold and appear in the stock of H at the date of the Consolidated Balance Sheet, there is an unrealized profit as far as the group is concerned and it must be eliminated in the preparation of the Consolidated Balance Sheet. On the other hand, if H has less than a 100 per cent holding in S, the profit *has* been realized from the point of view of the minority shareholders of S. Therefore, in such a case, the amount to be eliminated is H's proportion only. (If H had sold the goods to S at a profit, the proportion of profit belongs to H.)

This point will also arise when fixed assets are transferred from one company in a group to another at a book profit or loss, in which case such adjustments will be required as to leave the Consolidated Balance Sheet in the same position as if no transfer had taken place. Similarly, adjustment will be required to eliminate any profit made by a company manufacturing capital equipment which is sold as such to another company in the group, including depreciation.

Illustration. From the Balance Sheets and information given on page 1062, prepare Consolidated Balance Sheet.

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[1] The minority interest is unchanged, since it is not in any way concerned with the date of acquisition by H.

[2] Goodwill is greater than in the illustration on page 1057 by 80% of £200, i.e. £160, the Profit and Loss figure being correspondingly increased. The Goodwill figure is proved as follows—

	£	£
Cost of 1,600 Shares		2,700
Less nominal value of Shares . .	1,600	
80% of pre-acquisition Profit (£600)	480	
		2,080
		£620

BALANCE SHEETS AS AT 31ST DECEMBER, 19..

	H	S		H	S
	£	£		£	£
Share Capital— £1 fully paid	10,000	2,000	Sundry Assets	8,000	1,200
Profit and Loss	4,000	1,200	Stock	6,100	2,400
Reserve	1,000	600	Debtors	1,300	1,700
Creditors	2,000	1,200	Bills Receivable	100	
Bills Payable		300	Shares in S— 1,500 at Cost	1,500	
	£17,000	£5,300		£17,000	£5,300

(1) All the profit of S has been earned since the shares were acquired by H, but there was already the Reserve of £600 at that date.

(2) The bills accepted by S are all in favour of H which has discounted £200 of them.

(3) Sundry assets of S are under-valued by £200.

(4) The stock of H includes £500 bought from S at a profit to the latter of 25 per cent on cost.

CONSOLIDATED BALANCE SHEET

	H	S	Adjustments	Total		H	S	Adjustments	Total
	£	£	£	£		£	£	£	£
Share Capital	10,000	2,000	(*a*) − 1,500 (*b*) − 500	10,000	Sundry Assets	8,000	1,200	(*h*) + 200	9,400
					Stock	6,100	2,400	(*c*) − 75	8,425
Profit & Loss	4,000	1,200	(*c*) − 75 (*d*) − 300	4,825	Debtors	1,300	1,700		3,000
					Bills Receivable	100		(*g*) − 100	
Reserve	1,000	600	(*e*) − 150 (*f*) − 450	1,000	Shares in S	1,500		(*a*) − 1,500	
Creditors	2,000	1,200		3,200					
Bills Payable		300	(*g*) − 100	200					
Minority Interest			(*b*) + 500 (*d*) + 300 (*e*) + 150 (*h*) + 50	1,000					
Capital Reserve			(*f*) + 450 (*h*) + 150	600					
	£17,000	£5,300	−£1,475	£20,825		£17,000	£5,300	− £1,475	£20,825

Notes. (1) The adjustments have been lettered to facilitate reference.

(2) Item (*c*) represents the elimination of H's proportion of the unrealized profit on the sale of goods, i.e. 75 per cent of 20 per cent of £500 [or 25 per cent of £400]. It will be noticed that the adjustment is made to H's share of S's profit, so that the £300 transferred to Minority Interest includes their £25 proportion.

(3) Minority Interest is 25 per cent of (Share Capital + Profit and Loss + Reserve + Under-valuation of Sundry Assets) = 25 per cent of (£2,000 + £1,200 + £600 + £200) = 25 per cent of £4,000. [See (*b*), (*d*), (*e*), and (*h*).]

(4) Capital Reserve is—

	£		£
Share Capital of S . .	2,000		
Reserve	600		
Under-valuation of Assets .	200		
	£2,800	75% thereof =	2,100
Cost of Shares			1,500
Capital Reserve			£600

Preference Shares of Subsidiary. When the share capital of S consists of Preference as well as Ordinary shares—

(1) If they are all held by H no difficulty arises, the normal elimination being required.

(2) If some or all are held by outside shareholders the minority interest will be increased accordingly. The treatment will depend on the rights attaching to the shares as defined in the Memorandum and Articles of Association of the particular company. The term "Preference Share" has a wide meaning and the principles already outlined in the previous chapter must be applied. The following factors must be considered—

(*a*) Rights as to Capital on a liquidation—if there is a right to priority of repayment, the full amount must be added to minority interest, otherwise they will be treated as ordinary shares.

(*b*) Rights as to dividend—where there is no right to priority, they will usually be treated as ordinary shares; where there is such a right it must be taken into account, and if it is cumulative, any arrears should be provided for by adjusting the Profit and Loss Balance and increasing the minority interest. In regard to such arrears, there is of course no legal liability until the preference dividends are declared. If, however, the right is cumulative, arrears will have to be met before any dividend can be paid on the ordinary shares, and most accountants consider it preferable to make an adjustment for them. Alternatively, the matter could be dealt with in a note on the Consolidated Balance Sheet (see page 1097).

(*c*) Rights as to participation in profits beyond a fixed amount —where such a right exists it must be taken into account, since the balance of profit available to the ordinary shares is thereby reduced.

(3) In the books of S, if the shares are allotted to H as the original shareholder, the entries will be the same as if they had been allotted to an individual. If, on the other hand, H acquires the shares from the existing shareholders, no entries are required in the books of S, the necessary alterations being made in the usual way on a transfer of shares in the register of members, etc.

It must be remembered that in all cases where there are Preference Shares, the exact treatment will depend upon the facts in each particular instance.

SUMMARY OF RULES OF CONSOLIDATION

The basic principles of the preparation of the Consolidated Balance Sheet have now been outlined. Before proceeding with more intricate problems where there are several subsidiaries or where shares in the holding company are held by one or more of the subsidiaries and so on, the following summary of the more important factors is given—

(1) All inter-company indebtedness and profits (and losses) must be eliminated, including in the former share capital, debentures, loans and current accounts. The share capital of H, however, remains except that it is reduced by any of the shares held by S.

(2) Pre-acquisition profits and losses must be capitalized, such profits being in effect a reduction of the purchase price, thus reducing Goodwill or Cost of Control, or increasing Capital Reserve. Losses will have a converse result.

(3) The interest of the minority shareholders in S will require adjustment for their share of Share Capital, Reserves, Profits and/or Losses. The sharp distinction required in (2) does not arise in regard to the minority interest.[1]

(4) Elimination of unrealized profit on inter-company transactions to the extent of H's holding.

(5) Subject to these adjustments, all the assets and liabilities of the constituent companies are aggregated under common headings.

METHODS OF CONSOLIDATED BALANCE SHEET PREPARATION

As long as effect is given to the principles outlined, the method used in the preparation of the Consolidated Balance Sheet is of little importance and will depend to some extent on individual preference. The following methods are in use—

(1) Employment of an adjustment column on each side of the draft Consolidated Balance Sheet (as has been done in all the illustrations so far). There will thus be four columns (where there is one S) on each side, viz.: (1) H, (2) S, (3) Adjustments, (4) Total. Variations of this method are—

(*a*) To use plus and minus signs in the adjustment column.

(*b*) To split the adjustment column into Dr. and Cr.

(*c*) To eliminate completely in the adjustment column such items as shares in S, transferring the balance in that column to Goodwill or Capital Reserve and carrying out the final figure from there.

(*d*) Not to make the balancing transfer as in (*c*) but to extend the balance immediately with appropriate marking, e.g. G for Goodwill, M for Minority Interest, etc.

[1] There may be losses of subsidiaries which more than extinguish their issued capital, so that the Minority Shareholders' equity is in debit, but this is not a recoverable debt and should be separately shown as a deduction from the Group Reserves or Capital.

(2) Aggregation of the various items in the individual balance sheets in one column, the requisite transfers being made from/to these totals, the net result being extended into a final column. Thus, inter-company balances are eliminated by straight contra subtraction; pre-acquisition profits are transferred to Capital Reserve, from which the outside shareholders' proportion is transferred to Minority Interest, and so on. Variations of this method are—

(*a*) To make the net adjustments direct from the totals of the appropriate assets and liabilities.

(*b*) To employ a special column for eliminations.

(3) Preparation of a Schedule of Adjustments from which the Consolidated Balance Sheet is compiled.

(4) Employment of a journal, the journal entries being "posted" into an adjustment column just as if the Consolidated Balance Sheet were part of an actual double-entry account. (In practice and in complicated examination problems this procedure will be absolutely necessary. It may be mentioned here that in some of the recent examinations the journal entries would without any further work earn the bulk of the marks; indeed, in one recent question merely to write out the balance sheets in columnar form and the final aggregated figures would take at least half an hour.)

A comparison of these methods is given below. Journal entries will be illustrated in greater detail later in this chapter.

General Illustration. The Balance Sheets of H, Ltd. and S, Ltd. are—

BALANCE SHEETS AS AT 31ST OCTOBER, 1953

	H, Ltd.		S, Ltd.			H, Ltd.	S, Ltd.
		£		£		£	£
Share Capital (£1 fully pd)		2,000		500	Sundry Assets . .	2,000	1,300
Reserve (at 1st Nov., 1952)		300		100	Shares in S, Ltd at cost	2,300	
Profit and Loss Account							
Balance, 1st Nov., 1952	£600		£300				
Plus Profit for Year .	400		100				
		1,000		400			
Creditors . . .		1,000		300			
		£4,300		£1,300		£4,300	£1,300

H, Ltd., has an 80 per cent interest in S, Ltd., acquired half-way through the financial year. Included in sundry assets of H, Ltd., is £300 loan to subsidiary company (shown in the latter's Balance Sheet as creditors). Sundry assets of the subsidiary company include fittings of £400 to be revalued at £500 as at 1st November, 1952, being over-depreciation adjustment. It may be assumed that the profits are uniformly earned. Prepare Consolidated Balance Sheet.

(1*a*) [See also page 1067]—

CONSOLIDATED BALANCE SHEET

	H	S	Adjustments Dr	Adjustments Cr.	Total		H	S	Adjustments Dr.	Adjustments Cr.	Total
	£	£	£	£	£		£	£	£	£	£
Share Capital .	2,000	500	(*a*) 400		2,000	Sundry Assets	2,000	1,300	(*h*) 20	(*d*) 300	3,100
			(*b*) 100						(*j*) 80		
Reserve .	300	100	(*c*) 20		300	Shares in S	2,300			(*a*) 400	
			(*l*) 80							(*k*) 1,900	
P. & L. Balance	600	300	(*m*) 240		600						
			(*i*) 60			Goodwill			(*k*) 1,900	(*l*) 80	
Profit for Year .	400	100	(*f*) 10							(*e*) 40	
			(*g*) 10		440					(*j*) 80	1,460
			(*e*) 40							(*m*) 240	
Creditors .	1,000	300	(*d*) 300		1,000						
Minority Interest:											
Share Capital .				(*b*) 100							
Reserve				(*c*) 20							
P & L. Balance				(*i*) 60							
Profit for Year				(*f*) 10	220						
Profit for Year				(*g*) 10							
Increase of Assets				(*h*) 20							
	£4,300	£1,300	£1,260	£220	£4,560		£4,300	£1,300	£2,000	£3,040	£4,560
			£1,040						£1,040		

(1*b*) Alternatively—

CONSOLIDATED BALANCE SHEET OF H, LTD., AND ITS SUBSIDIARY, S, LTD., AS AT 31ST OCTOBER, 1953

	H, Ltd.	S, Ltd.	Adjustments	Total		H, Ltd.	S, Ltd.	Adjustments	Total
	£	£	£	£		£	£	£	£
Share Capital	2,000	500	(*a*) − 500	2,000	Sundry Assets	2,000	1,300	(*e*) + 100 − 300	3,100
Reserve	300	100	(*b*) − 100	300					
Profit and Loss Account	600	300	(*c*) − 300	600	Shares in S, Ltd.	2,300		(*f*) −2,300	
Profit for Year	400	100	(*d*) − 60	440	Goodwill			+ 1,460	1,460
Minority Shareholders (as per Schedule in (3))			+ 220	220					
Creditors	1,000	300	− 300	1,000					
	£4,300	£1,300	− £1,040	£4,560		£4,300	£1,300	− £1,040	£4,560

Note. The lettered references are to the Schedule given in (3) on page 1068. Where there is no Schedule the adjustments will be given in detail as in previous illustrations in this chapter.

(2) CONSOLIDATED BALANCE SHEET

		£	£
Share Capital (H)			2,000
Capital Reserve—			
Reserve of S at date of acquisition		100	
Pre-acquisition Profit		350	
Increase of Assets		100	
		550	
Less M.I. 20%		110	
		440	
Deducted Contra		440	
General Reserve—			
H		300	
S	£100		
Less Transfer to C.R.	100	—	
			300
Profit and Loss Account—			
H Balance		600	
Profit for Year		400	
		1,000	
S Balance	£300		
Profit for Year	100		
	400		
Transfer to C.R.	350		
Post-acquisition Profit	50		
Less M.I. 20%	10		
		40	
			1,040
Creditors—			
H		1,000	
S	£300		
Less Contra	300	—	
			1,000
Minority Interest—			
Share Capital		100	
Capital Reserve		110	
Profit and Loss		10	
			220
			£4,560

		£	£
Sundry Assets—			
H		2,000	
S	£1,300		
Less Contra	300		
	1,000		
Increase to C.R.	100		
		1,100	
			3,100
Goodwill—			
Cost of Shares		2,300	
Nominal Share Capital—S	£500		
Less M.I. 20%	100		
		400	
		1,900	
Less C.R. Contra		440	
			1,460
			£4,560

Note. M.I. = Minority Interest. C.R. = Capital Reserve.

(3) SCHEDULE OF ADJUSTMENTS

	H, Ltd. (80%)	Minority Shareholders S, Ltd. (20%)
	£	£
Share Capital	400	100 (a)
Balance of Profit and Loss Account	240	60 (c)
Profit to date of purchase of Shares by H, Ltd.	40	10 (d)
Increase of Sundry Assets	80	20 (e)
Reserve	80	20 (b)
	840	210
Goodwill	1,460	
	£2,300 (f)	210
Profit since purchase of Shares by H, Ltd.	40	10 (d)
		£220

The reference letters are to the Consolidated Balance Sheet in (1b) on p. 1067.

(4) A full Journal illustration will be given on pages 1092 and 1093. The entries will, however, be the same as those shown in the Dr. and Cr. adjustments in (1) on page 1066, thus for item (a)—

		£	£
Share Capital of S.	Dr	400	
To Shares in S			400

Many of the individual entries may be consolidated in the journal, thus for items (a) and (k)—

			£	£
	Goodwill	Dr.	1,900	
	Share Capital of S.	Dr.	400	
	To Shares in S			2,300

Profits and Dividends of Subsidiaries. The alternative treatment of the profits of subsidiaries in the books of the holding company was considered in the early pages of this chapter and it will be remembered that it is sometimes the practice to "take up" such profits whether dividends are declared by S or not. Where this practice obtains, a Profit of Subsidiaries Account is debited with H's proportion of the profits and a Profits and Losses of Subsidiaries Account (which may be closed off to Profit and Loss Account) credited. When a dividend is paid, cash is debited and the Profit

of Subsidiary Account credited. The effect of these alternatives on the Consolidated Balance Sheet is now considered—

(1) Where not taken up, the position is straightforward, as has been shown in all the illustrations so far. After the necessary adjustments for pre-acquisition profits, minority interest, etc., the profits of H and S are added and extended into the total column.

(2) Where the profits have been taken up, H's proportion will be already included in H's profit balance and, therefore, in the Consolidated Balance Sheet H's proportion of S's profit balance must be eliminated against the balance of Profit of Subsidiary Account in H's Balance Sheet.

Where dividends are paid out of pre-acquisition profits, they must be adjusted against the cost of the shares in S. Where paid out of post-acquisition profits, the ultimate result in the Consolidated Balance Sheet is unchanged since H's profit balance, increased by the receipt of the dividend, is added to S's profit balance which has been decreased by the like amount. The treatment of dividends in the consolidated accounts is dealt with fully on page 1095 *et seq.*

Group Consisting of more than One Subsidiary. Where H holds shares in more than one subsidiary, no particular difficulty arises and there will be no departure from the principles already given. The goodwill or cost of control must be ascertained for each company and then the normal adjustments, eliminations, and aggregation will take place.

Illustration. From the following skeleton Balance Sheets and the information given, prepare the Consolidated Balance Sheet. Ignore tax.

BALANCE SHEET AS AT 31ST DECEMBER, 19..

	H	S	Y		H	S	Y
	£	£	£		£	£	£
Share Capital—				Sundry Assets	1,350	1,500	1,200
£1 fully paid	3,000	1,000	800	Profit of S Account	450		
Profit and Loss	100	200	300	900 Shares in S at cost	1,200		
Profit for Year	800	300	100	600 Shares in Y at cost	900		
	£3,900	£1,500	£1,200		£3,900	£1,500	£1,200

(1) The credit balance of Profit and Loss Account of Y was £300 when the shares therein were acquired by H, but the whole of the profits of S have been earned since acquisition of its shares by H.

(2) It was the practice of H to take up in its books its proportion of the profits of S.

(3) Y had during the year to 31st December, 19.., declared and paid a dividend of £80, reducing the profit for the year from £180 to £100.

Consolidated Balance Sheet

	H	S	Y	Adjustments	Total		H	S	Y	Adjustments	Total
	£	£	£	£	£		£	£	£	£	£
Share Capital .	3,000	1,000	800	(a) − 1,800	3,000	Sundry Assets	1,350	1,500	1,200		4,050
P. & L. . .	100	200	300	(b) − 825	975	Profit of S A/c	450			(b) − 450	
Profit for Year	800	300	100			Shares in S .	1,200			(a) − 900	300 G[1]
Minority Interest . .				(a) + 300		Shares in Y .	900			(a) − 600	75
				(b) + 150	450					(b) − 225	
	£3,900	£1,500	£1,200	− £2,175	£4,425		£3,900	£1,500	£1,200	− £2,175	£4,425

[1] G = Goodwill.

(*a*) Elimination of Share Capitals—

		Total		*H*		*M.I.*
		£		£		£
S	. . . .	1,000	(90%)	900	(10%)	100
Y	. . . .	800	(75%)	600	(25%)	200
		£1,800		£1,500		£300

(*b*) Elimination of Profit and Loss—

	Balance	*Profit for Year*		*Against Cost of Shares*		*Profit of S Account*		*Interest of H in P. and L.*		*M.I.*
	£	£		£		£		£		£
S . .	200				(90%)	180			(10%)	20
Y . .	300		(75%)	225					(25%)	75
S . .		300			(90%)	270			(10%)	30
Y . .		100					(75%)	75	(25%)	25 (*a*)
	£500[1]	£400[1]		£225		£450		£75[1]		£150

	S	Y	*Total*
G (Goodwill) is—	£	£	£
Cost of Shares	1,200	900	2,100
Less Equity acquired—			
90% of Share Capital (£1,000) + Pre-acquisition Profit (*nil*) . . .	900		
75% of Share Capital (£800) + Pre-acquisition Profit (£300) . .		825	1,725
	£300	£75	£375

The dividend paid by Y during the year can be ignored in the preparation of the Consolidated Balance Sheet, the adjustments being made to the remaining balance. The total profit of £180 is apportionable as to 25 per cent (£45) to Minority Interest and 75 per cent (£135) to H. As the minority shareholders have received 25 per cent of the dividend, i.e. £20, their interest shown in the Consolidated Balance Sheet will be confined to the balance, i.e. £45 less £20 = £25 (see (*a*) above). As to H's proportion of the dividend, this will be included in H's profit for the year and will thus appear in the Profit total for the group. The assumption that the dividend is included in H's profit is based on the fact that Shares in Y are shown in the Balance Sheet of H at cost. It must be remembered that only dividends paid out of post-acquisition profits may be regarded as revenue by H. If the dividend were paid out of the balance of Profit and Loss Account at the date of acquisition it would be of a capital nature and must be adjusted against the cost of the shares by crediting Shares in Y Account. In the Consolidated Balance Sheet this would alter the Goodwill figure accordingly.

[1] £500 + £400 = £900 *less* £75 remaining in P. & L. makes the net adjustment of £825 shown in the C.B.S.

Shares of Holding Company held by Subsidiary. Although a company cannot hold its own shares, a subsidiary can hold shares in its holding company, so that, in fact, the latter does have an interest in its own shares. In this connection, however, the following section of the Companies Act, 1948, should be noted—

27.—(1) Except in the cases hereafter in this section mentioned, a body corporate cannot be a member of a company which is its holding company, and any allotment or transfer of shares in a company to its subsidiary shall be void.

(2) Nothing in this section shall apply where the subsidiary is concerned as personal representative, or where it is concerned as trustee, unless the holding company or a subsidiary thereof is beneficially interested under the trust and is not so interested only by way of security for the purposes of a transaction entered into by it in the ordinary course of a business which includes the lending of money.

(3) This section shall not prevent a subsidiary which is, at the commencement of this Act,[1] a member of its holding company, from continuing to be a member; but, subject to the last foregoing subsection, the subsidiary shall have no right to vote at meetings of the holding company or any class of members thereof.

(4) Subject to subsection (2) of this section, subsections (1) and (3) thereof shall apply in relation to a nominee for a body corporate which is a subsidiary, as if reference in the said subsections (1) and (3) to such a body corporate included references to a nominee for it.

(5) In relation to a company limited by guarantee or unlimited which is a holding company, the reference in this section to shares, whether or not it has a share capital, shall be construed as including a reference to the interest of its members as such, whatever the form of that interest.

In preparing the Consolidated Balance Sheet in these circumstances, no difficulty arises when the Holding Company owns all the shares in the subsidiary, the normal adjustments being made. Where, however, there is a minority interest in the subsidiary, the work is more involved, for it will be seen that this interest is, as it were, twofold viz. (*a*) in the equity of the subsidiary and (*b*) in the equity of the holding company by reason of the shares held in that company by the subsidiary. The most accurate way to compute the minority interest is to assume that all available profits are distributed at the date of the Consolidated Balance Sheet. The principle involved is shown by the following illustration—

BALANCE SHEETS

	H	S		H	S
	£	£		£	£
Share Capital £1 f.p.	500	100	Sundry Assets	480	90
Post-acquisition Profits	100	50	Shares in S (75)	120	
			Shares in H (50)		60
	£600	£150		£600	£150

1st July, 1948.

In the normal way the minority interest in S will be $\frac{1}{4}$ of share capital and profits i.e. £25 plus £12 10s., but the latter figure takes no account of S's share of H's profits. The actual amount which would accrue to the minority shareholders if the whole £150 were distributed can be ascertained in the following way (to the nearest £)—

	H	S	Outside Shareholders in S	Outside Shareholders in H
	£	£	£	£
Profits per Balance Sheet	100	50		
S's Profit distributed	+ 38	− 50	+ 12	
	138	—		
H's Profit distributed	− 138	+ 14		+ 124
	—	14		
S's Profit distributed	+ 10	− 14	+ 4	
	10	—		
H's Profit distributed	− 10	+ 1		+ 9
	—	1		
S's Profit distributed	+ 1	− 1		
	1	—		
H's Profit distributed	− 1			+ 1
Distribution	—	—	£16	£134

The above has been given to illustrate what is being done; in practice the calculation will be by algebra as follows—

Let H = total profits of H and S = total profits of S.

Then $H = 100 + \frac{3}{4} S$, and $S = 50 + \frac{1}{10} H$

Thus $H = 100 + \frac{3}{4} (50 + \frac{1}{10} H) = 100 + \frac{150}{4} + \frac{3}{40} H$

$\therefore \; 40H = 4{,}000 + 1{,}500 + 3H$

$\therefore \; 37H = 5{,}500$

$\therefore \; H = 149$ and $S = 50 + 15 = 65$.

Allocation of Profits—	H	S
Profits per Balance Sheet	£100	£50
Add $\frac{3}{4}$ of total profit of S	49	
$\frac{1}{10}$ of total profit of H		15
Total profits as above	149	65
Less amounts added above	(*a*) 15	(*b*) 49
	£134	£16

(*a*) = 10% × £149; (*b*) = 75% × £65.

The true minority interest in the profits is therefore £16 as opposed to £12 10s.

CONSOLIDATED BALANCE SHEET

		£		£
Share Capital . . .		450	Sundry Assets . . .	570
Profit and Loss Account .		134	Goodwill	55
Minority Interest—			[£180 − £75 − £50]	
Share Capital . .	£25			
Profit and Loss .	16			
		41		
		£625		£625

Illustration. The Balance Sheets of H, Ltd. and S, Ltd. are—

BALANCE SHEETS

	H, Ltd.	S, Ltd.		H, Ltd.	S, Ltd.
	£	£		£	£
Share Capital	3,000	1,500	Sundry Assets	1,300	1,550
Profit and Loss Account. Profit for Year	300	200	1,200 Shares in S, Ltd. at cost	2,000[1]	
			100 Shares in H, Ltd. at cost		150[1]
	£3,300	£1,700		£3,300	£1,700

Prepare Consolidated Balance Sheet.

(1) If the mutual purchases took place at the date of the above Balance Sheet—

CONSOLIDATED BALANCE SHEET OF H, LTD., AND ITS SUBSIDIARY, S, LTD., AS AT........

	£	£		£	£
Share Capital	3,000		Sundry Assets		2,850
Less Shares held by S, Ltd. .	100	2,900	Goodwill	850	
			Less Reserve *per contra* .	167	683[1]
Reserve—					
Proportion of Profits attributable to H, Ltd., as at	167[1]				
Less Contra	167	—			
Profit and Loss Account (H, Ltd.)		290			
Minority Shareholders—					
Share Capital . . .	300				
Profit and Loss Account .	43	343			
		£3,533			£3,533

(2) If they took place at the start of the accounting period—

[1] Goodwill = Cost of Shares £2,150, *less* Nominal Value of Shares £1,300, *less* Profit £167. See page 1075. Of the total of the Profit and Loss Accounts of £500, £457 is applicable to H, Ltd., and H, Ltd.'s own account should be shown as £290 (i.e. £300 less $\frac{1}{30}$th bought in by the Group), leaving £167 to be carried to Capital Reserve.

CONSOLIDATED BALANCE SHEET OF H, LTD., AND ITS SUBSIDIARY, S, LTD., AS AT........

	£	£		£	£
Share Capital	3,000		Sundry Assets		2,850
Less Shares held by S, Ltd.	100		Goodwill		850[1]
		2,900			
Profit and Loss Account—					
(H, Ltd.)	300				
(S, Ltd.)	157				
		457			
Minority Shareholders—					
Share Capital	300				
Profit and Loss Account	43				
		343			
		£3,700			£3,700

In the second case all the profits are earned after the acquisition of the shares and so no deduction is made from the £850 goodwill figure. The proportion of the combined profits of H, Ltd., and S, Ltd., for the year applicable to the shareholders of H, Ltd., is £457. The precise split of this figure between H, Ltd., and S, Ltd., is somewhat academic. A division on a complete distribution of profits can be worked out by simple arithmetic as £298 to H, Ltd., and £159 to S, Ltd., but it seems rather doubtful whether there is any merit in showing such a split. It seems better to leave H, Ltd.'s account at its actual figure of £300 and to carry the adjustment in S, Ltd.'s figure.

The calculations are—

$$H = 300 + \tfrac{4}{5}S$$
$$S = 200 + \tfrac{1}{10}H \qquad (1)$$
$$5H = 1{,}500 + 4(200 + \tfrac{1}{30}H)$$
$$H = \underline{\pounds 473}$$

$$\text{and} \quad S = 200 + \tfrac{1}{30}(473) \qquad (1)$$
$$= \underline{\pounds 216}$$

Allocation of Profits—

	H, Ltd.	S, Ltd.
	£	£
Balances per Accounts	300	200
Add 12/15 of £216	173	
,, 1/30 of £473		16
	473	216
Less 12/15 of £216		173
,, 1/30 of £473	16	
Balance, H, Ltd.'s Interest therein	£457	
Proportion attributable to Minority Shareholders [1/5 of £216]		£43

[1] Goodwill = £2,150 − £1,300.

Alternative Method—

	H, Ltd.	S, Ltd.
	£	£
Sundry Assets	1,300	1,550
Goodwill	800	50
	2,100	1,600
Equity $\frac{4}{5}$ of £1,716	1,373	
$\frac{1}{30}$ of £3,473		116
[See below]	3,473	1,716
Less Proportion due to S, Ltd. (Share Capital £100 + Profits £16)	116	
Less Proportion due to H, Ltd. (Share Capital £1,200 + Profits £173)		1,373
(a) Share Capital £2,900 plus Profit £457, (b) Share Capital £300 plus Profit £43.	(a) £3,357	(b) £343

The calculations are—

$$S = £1,600 + \tfrac{1}{30} H$$

$$H = £2,100 + \tfrac{4}{5} S$$

The results are—

$$S = £1,716$$

$$H = £3,473$$

Illustration. *Where both the holding company and a subsidiary between them own all the shares of another company.*

The following are the Balance Sheets, as on the 31st December, 19.., of the respective companies.

"A"

	£		£
Share Capital, 200,000 Shares of £1 each	200,000	Land and Buildings	64,000
Reserve and Profit and Loss Account	63,600	Plant and Machinery	32,500
Sundry Creditors	73,400	B Co., Ltd., 40,000 Shares of £1 each	40,000
B Co., Ltd., Loan Account	15,000	C Co., Ltd., 10,000 Ordinary Shares of £1 each	10,000
		C Co., Ltd., Current Account	8,000
		Sundry Debtors	94,000
		Stock	87,000
		Bank and Cash	16,500
	£352,000		£352,000

"B"

	£		£
Share Capital, 50,000 Shares of £1 each	50,000	Patents	24,500
Profit and Loss Account	12,700	C Co., Ltd., 6,000 Ordinary Shares of £1 each	8,000
Sundry Creditors	28,000	A Co., Ltd., Loan Account	15,000
C Co., Ltd., Current Account	44,300	Sundry Debtors	44,500
		Stock	40,000
		Bank and Cash	3,000
	£135,000		£135,000

"C"

	£		£
Share Capital—		B Co., Ltd., Current Account	44,300
10,000 Preference Shares of £1 each . . .	10,000	B Co., Ltd., 10,000 Shares of £1 each . . .	10,000
20,000 Ordinary Shares of £1 each . . .	20,000	Sundry Debtors . .	46,000
Sundry Creditors . .	120,000	Stock	42,000
A Co., Ltd., Current Account	8,000	Bank and Cash . .	2,700
		Profit and Loss Account .	13,000
	£158,000		£158,000

You are required to prepare a draft Consolidated Balance Sheet of "A" Co., Ltd. and its subsidiaries. It is to be assumed that the preference shares of "C" Co., Ltd., have a prior right to repayment of capital in liquidation, that the whole of the above profits and losses have arisen since the holding company and the subsidiary companies acquired the shares, and that no abnormal "internal" items exist. Ignore the question of preference dividend. Balance Sheets in abridged form are:

	"A"	"B"	"C"		"A"	"B"	"C"
	£	£	£		£	£	£
Share Capital .	200,000	50,000	20,000	Sundry Assets .	294,000	112,000	90,700
do. Preference			10,000	*"C" Co., Current* .	*8,000*		
Reserve and Profit and Loss Account	63,600	12,700		*"A" Co., Loan* .		*16,000*	
Sundry Creditors .	73,400	28,000	120,000	*"B" Co., Current* .			*44,300*
"A" Co., Current .			*8,000*	Profit and Loss Account . .			13,000
"B" Co., Loan .	*16,000*			Shares—			
"C" Co., Current .		*44,300*		"B" Co. . .	40,000		10,000
				"C" Co. . .	10,000	8,000	
	£352,000	£135,000	£158,000		£352,000	£135,000	£158,000

CONSOLIDATED BALANCE SHEET OF "A" CO., LTD., AND ITS SUBSIDIARIES, AS AT 31ST DECEMBER, 19. .

			£		£
Share Capital, 200,000 Shares of £1 each fully paid			200,000	Sundry Assets [£294,000 + £112,000 + £90,700]	496,700
	£	£		Goodwill	2,000
Profit and Loss Account—					
"A" Co., Profit [Reserve?] . .	63,600				
"B" Co, Profit . .	7,490				
		71,090			
Less "C" Co., Loss .		5,564			
			65,526		
Minority Shareholders—					
Preference Shares, "C" Co. . . .		10,000			
Ordinary Shares, "C" Co. . . .	4,000				
Less Proportion of Loss . . .	2,226				
		1,774			
			11,774		
Sundry Creditors [£73,400 + £28,000 + £120,000]			221,400		
			£498,700		£498,700

Schedule of Profit and Loss Accounts

	"A" Co.	"B" Co.	"C" Co.
	£	£	£
Balances per Accounts	63,600	12,700	*- 13,000*
Add $\frac{1}{5}$ × £9,362			+ 1,872
Less $\frac{3}{10}$ × £11,128		3,338	
		9,362	*- 11,128*
Proportion of "C" Co.		1,872	
Proportion of "B" Co.			*- 3,338(a)*
Balances: "A" Co.'s Interest therein	£63,600	£7,490	
Proportion attributable to "A" Co.			*- 5,564(b)*
" " " *Minority Shareholders*			*- £2,226(c)*

(*a*) $\frac{3}{10}$ of £11,128; (*b*) $\frac{10}{20}$ of £11,128; (*c*) $\frac{4}{20}$ of £11,128.

The calculations are—

Let x = balance of "B" Profit and Loss Account
y = balance of "C" Profit and Loss Account

Then $x = +12{,}700 + \frac{3}{10}y$ . . . . (1)
$y = -13{,}000 + \frac{1}{5}x$

Substituting y for x,

$$y = -13{,}000 + \tfrac{1}{5}(12{,}700 + \tfrac{3}{10}y)$$
$$= -13{,}000 + 2{,}540 + \cdot 06y$$
$$\cdot 94y = -10{,}460$$
$$\therefore\ y = -£11{,}128$$

Hence, $x = +12{,}700 + \frac{3}{10}y$ . . . . (1)
$$= +12{,}700 - 3{,}338$$
$$= +£9{,}362$$

Alternative Method.

		"A" Co.	"B" Co.	"C" Co.
		£	£	£
Sundry Assets (including "Internal" Loans and Current Accounts, Goodwill, but excluding Par Value of Shares held)		302,000	120,000	135,000
Less Liabilities		88,400	72,300	138,000
(As below)		£213,600	£56,700	- £3,000
Or				
[Capitals and Undistributed Profits—				
Share Capitals		200,000	50,000	20,000
Profit and Loss Accounts		63,600	12,700	- 13,000
		263,600	62,700	7,000
Less Shares in	"B" £40,000			"B" 10,000
	"C" 10,000		"C" 6,000	
		50,000		
(As above)		£213,600	£56,700	- £3,000]

The amount receivable by "C" Co. from "B" Co. is £11,872, arrived at as follows—

As "B" Co. holds $\frac{6}{20}$ of the ordinary shares of "C" Co. the total equity of the former company is—

$$B = 56{,}700 + \tfrac{3}{10}C$$
$$B - \tfrac{3}{10}C = 56{,}700$$
$$10B - 3C = 567{,}000$$

As "C" Co. holds $\frac{1}{5}$ of the shares of "B" Co. the total equity of the former company is—

$$C = \tfrac{1}{5}B - 3{,}000$$

$$\tfrac{1}{5}B - C = 3{,}000 \quad \left[\text{Alternatively by substitution } C = \frac{56{,}700 + \frac{3}{10}C}{5} - 3{,}000 = £8{,}872\right.$$

$$\mathit{10B{-}50C = 150{,}000}$$

Combined, the italicized equations are—

$$\begin{aligned} 10B - 3C &= 567{,}000 \\ 10B - 50C &= 150{,}000 \\ \hline 47C &= 417{,}000 \\ \text{Hence} \quad C &= £8{,}872 \end{aligned}$$

As the total equity of the ordinary shares of "C" Co. is £8,872, the latter company must be entitled to £11,872, as without such appropriation the equity was a minus quantity of £3,000.

The whole of the equities may now be computed, thus—

		"A"		"B"		"C"
		£		£		£
Equity (other than Shares) . .		213,600		56,700		− 3,000
Amount receivable from—	£					
"B" Co. ($\frac{4}{5}$) . . .	47,490				"B" Co. $\frac{1}{5}$	11,872
"C" Co. ($\frac{1}{2}$) . . .	4,436		"C" Co. $\frac{3}{10}$	2,662		
		51,926				
Total [per (*a*) and (*b*) below] . .		£265,526		59,362		8,872
Less payable to			"C" Co. $\frac{1}{5}$	11,872	"B" Co.	2,662
				47,490		6,210
Less payable to			"A" Co.	47,490	"A" Co.	4,436
Balance attributable to Minority Shareholders [see (*c*) below] .						£1,774

CONSOLIDATED BALANCE SHEET OF "A" CO., LTD., AND ITS SUBSIDIARIES, AS AT 31ST DECEMBER, 19..

			£		£
Share Capital, 200,000 shares of £1 each fully paid		(*a*)	200,000	Sundry Assets	496,700
				Goodwill	2,000
Profit and Loss Account—	£	£			
"A" Co. . . .		63,600			
"B" Co.—					
Equity . . .	47,490				
Less Shares . .	40,000				
		7,490			
		71,090			
Less "C" Co. Shares .	10,000				
Less Equity . .	4,436				
		5,564			
		(*b*)	65,526		
Minority Shareholders—					
Preference Shares, "C" Co.		10,000			
Ordinary Shares, "C" Co.—					
Share Capital .	4,000				
Less Proportion of Loss . .	2,226				
		(*c*) 1,774			
			11,774		
Sundry Creditors . .			221,400		
			£498,700		£498,700

The equity of the preference shareholders remains undisturbed, as there are sufficient assets to pay them in full.

If the preference shareholders of "C" Co. are not preferential as to capital, their equity will be proportionately reduced. As the capital of "C" Co. is £30,000, the proportions of the equity are: "A" Co., $\frac{10}{30}$; "B" Co., $\frac{6}{30}$; minority ordinary shareholders, $\frac{4}{30}$; and preference shareholders, $\frac{10}{30}$.

The calculations in this event are—

$$A = 63{,}600 + \tfrac{4}{5}B + \tfrac{1}{3}C$$
$$B = 12{,}700 + \tfrac{1}{5}C$$
$$C = -13{,}000 + \tfrac{1}{5}B$$

The results are: C = −£10,896, B = + £10,521, minority shareholders of C = −£1,453, and preference shareholders of C = −£3,632.

SCHEDULE OF PROFIT AND LOSS ACCOUNTS

	"A" Co.	"B" Co.	"C" Co.
	£	£	£
Balances per Accounts . .	63,600	12,700	− 13,000
Add $\frac{1}{5}$ × £10,521 . . .			+ 2,104
Less $\frac{6}{30}$ × £10,896 . . .		− 2,179	
		10,521	− 10,896
Proportion of "C" Co., $\frac{1}{5}$ . .		− 2,104	
Proportion of "B" Co., $\frac{6}{30}$ . .			− 2,179
			− 8,717
Balances: "A" Co's interest therein	£63,600	£8,417	− 3,632
Proportion attributable to Minority Shareholders—			− 5,085
Preference: $\frac{10}{30}$ × £10,896 .			−£3,632
Ordinary: $\frac{4}{30}$ × £10,896 .			−£1,453 −£5,085

The Consolidated Balance Sheet will be modified as follows—

	(1) Where Preference Shareholders have no Priority [as above]			(2) Where Preference Shareholders have Priority [as on pages 1077 and 1079]
	£	£	£	£
Minority Shareholders—				
Preference Shares, "C" Co.	10,000			
Less Proportion of Loss .	3,632			
		6,368		
Ordinary Shares . .	4,000			
Less Proportion of Loss .	1,453			
		2,547		
			8,915	11,774
Profit and Loss Account—				
"A" Co: Profit [Reserve?]		63,600		
"B" Co.: Profit . .		8,417		
		72,017		
Less "C" Co.: Loss .		3,632		
			68,385	65,526
			£77,300	£77,300

A much simpler but slightly less accurate way of dealing with this problem is for B not to take up its share of C's loss, thus simplifying the allocation of B's profit. The debit balance of C is therefore dealt with as follows—

B's profit of £12,700 is reduced by $\frac{1}{5}$ attributable to C's holding, i.e. £2,540, so that the loss of C is reduced thereby to £10,460. This is applicable as to $\frac{1}{5}$ (£2,092) to minority shareholders and $\frac{4}{5}$ (£8,368) against the combined profit of A and B. The consolidated Balance Sheet will now be as shown on page 1082, the above adjustments being in heavy type.

Illustration. The following are the abridged Balance Sheets of H, Ltd., and its subsidiaries at 31st December, 19...

All the profits and losses have arisen *subsequent* to the dates of purchase of all the shares which have been acquired.

BALANCE SHEETS AS AT 31ST DECEMBER, 19..

	H, Ltd.	A, Ltd.	B, Ltd.		H, Ltd.	A, Ltd.	B, Ltd.
	£	£	£		£	£	£
Share Capital .	5,000	2,500	2,000	Sundry Assets .	4,000	4,150	1,000
Profit and Loss Account . .	3,000	1,950		Shares in—			
				A, Ltd. (2,000) at cost . .	2,200		
				B, Ltd. (1,500) at cost . .	1,800		
				B, Ltd. (200) at cost . .		300	
				H, Ltd. (500) at cost . .			600
				Profit and Loss Account . .			400
	£8,000	£4,450	£2,000		£8,000	£4,450	£2,000

Prepare Consolidated Balance Sheet of the holding company (H, Ltd.) and its subsidiaries.

CONSOLIDATED BALANCE SHEET OF H, LTD., AND ITS SUBSIDIARIES, AS AT 31ST DECEMBER, 19..

	£	£	£		£	£	£
Share Capital . . .		5,000		Sundry Assets . . .			9,150
Less Share Capital held by B, Ltd. . .		500		Goodwill . . .			700
			4,500				
Profit and Loss Account .		4,611					
Less Proportion due to B, Ltd. . . .		461					
			4,150				
Minority Shareholders—							
A, Ltd.:							
Share Capital [$\frac{1}{5}$ × £2,500] . .	500						
Profit and Loss Account [$\frac{1}{5}$ × £1,956] . .	391						
		891					
B, Ltd.:							
Share Capital [$\frac{3}{20}$ × £2,000] .	300						
Profit and Loss Account [$\frac{3}{20}$ × £61] . .	9						
		309					
			1,200				
			£9,850				£9,850

Consolidated Balance Sheet

	A	B	C	Adjustments Dr.	Adjustments Cr.	Total
	£	£	£	£	£	£
Share Capitals—						
Ordinary	200,000	50,000	20,000	50,000		200,000
				16,000		
				4,000		
Preference			10,000	10,000		
Reserve and P.&L	63,600	12,700		2,540		65,392
				8,368		
Creditors	73,400	28,000	120,000			221,400
Current Accounts	15,000	44,300	8,000	67,300		
Minority Interest:						
Pref. Shares C					10,000	
Ord. Shares C					4,000	11,908
Loss C				2,092		
	£352,000	£135,000	£158,000	£160,300	£14,000	£498,700
				£146,300		

	A	B	C	Adjustments Dr.	Adjustments Cr.	Total
	£	£	£	£	£	£
Sundry Assets	294,000	112,000	90,700			496,700
Current Accounts	8,000	15,000	44,300		67,300	
Shares in—						
B	40,000		10,000		50,000	
C	10,000	8,000			16,000	
					2,000	
Goodwill				2,000		2,000
Profit and Loss			13,000		2,540	
					8,368	
					2,092	
	£352,000	£135,000	£158,000	£2,000	£148,300	£498,700
				£146,300		

Schedule of Profit and Loss Accounts

	H, Ltd. £	£	A, Ltd £	B, Ltd. £	£
Balances per Accounts		3,000	1,950		- 400
Add $\frac{4}{5}$ × £1,956—A's Profit	1,565				
,, $\frac{3}{4}$ × £61—B's Profit	46	1,611			
Add $\frac{1}{10}$ × £61			6		
Add $\frac{1}{10}$ × £4,611					+ 461
		4,611	1,956		61
Less due to B [$\frac{1}{10}$]		461			
,, due to H [$\frac{4}{5}$]			1,565		
,, due to A [$\frac{1}{10}$]				6	
,, due to H [$\frac{3}{4}$]				46	52
H, Ltd.'s Interest therein [as on page 1081]		£4,150			
Proportion attributable to Minority Shareholders [as on page 1081]			£391		£9

The calculations are—

$$H = 3{,}000 + \tfrac{4}{5}A + \tfrac{3}{4}B \qquad (1)$$
$$A = 1{,}950 + \tfrac{1}{10}B \qquad (2)$$
$$B = -400 + \tfrac{1}{10}H \qquad (3)$$
$$H = 3{,}000 + \tfrac{4}{5}(1{,}950 + \tfrac{1}{10}B) + \tfrac{3}{4}B \qquad (1) \text{ and } (2)$$
$$= 3{,}000 + 1{,}560 + \frac{4B}{50} + \frac{3B}{4} = 4{,}560 + \frac{83B}{100}$$
$$\therefore \quad H = \mathit{4{,}560 + {\cdot}83B}$$
$$\text{but} \quad H = \mathit{4{,}000 + 10B} \qquad (3)$$

Combining the italicized items—

$$\therefore \quad 9{\cdot}17B = 560$$
$$\therefore \quad B = £61{\cdot}1$$
$$\text{and} \quad A = 1{,}950 + \tfrac{1}{10}(61) \qquad (2)$$
$$= £1{,}956 \text{ [to nearest £]}$$
$$\text{and} \quad B = -400 + \tfrac{1}{10}H \qquad (3)$$
$$\therefore \quad 61{\cdot}1 = -400 + \tfrac{1}{10}H$$
$$\therefore \quad H = 4{,}000 + 611$$
$$= £4{,}611 \text{ [to nearest £]}$$

There is no necessity to calculate ALL the profits as, having obtained one result, one may connect up the remainder.

Alternative Method.

	H, Ltd. £	£	A, Ltd. £	B, Ltd. £	£
Sundry Assets		4,000	4,150		1,000
Goodwill		500	100		100
Equity: $\frac{4}{5}$ × £4,456	3,565				
$\frac{3}{4}$ × £2,061	1,546	5,111			
$\frac{1}{10}$ × £2,061			206		
$\frac{1}{10}$ × £9,611					961
		9,611	4,456		2,061
Less Proportion due to B, Ltd., $\frac{1}{10}$: [Share Capital £500 *plus* Profit £461]		961			
,, Proportion due to H, Ltd., $\frac{4}{5}$: [Share Capital £2,000 *plus* Profit £1,565]			3,565		
,, Proportion due to H, Ltd., $\frac{3}{4}$: [Share Capital £1,500, *plus* Profit £46]				1,546	
,, Proportion due to A, Ltd., $\frac{1}{10}$: [Share Capital £200, *plus* Profit £6]				206	1,752
H, Ltd.'s Interest therein [as on page 1081]: [Share Capital £4,500, *plus* Profit £4,150]		£8,650			
[1]Proportion attributable to Minority Shareholders [as on page 1081]			£891		£309

[1] See page 1085 for calculations.

Balance Sheets as at 31st December, 19.. (see page 1085)

	H, Ltd.	A, Ltd.	B, Ltd.	C, Ltd.
	£	£	£	£
Share Capital—				
Ordinary	20,000	5,000	10,000	4,000
Preference		5,000		6,000
Profit and Loss Account	6,000	2,000		3,000
Debentures		10,000		
Creditors	4,000	8,000	6,000	2,000
B, Ltd., Loan		3,000		
	£30,000	£33,000	£16,000	£15,000

	H, Ltd.	A, Ltd.	B, Ltd.	C, Ltd.
	£	£	£	£
Sundry Assets	7,600	31,000	12,000	13,300
Ordinary Shares in A, Ltd.: 5,000 at 24s. each	6,000			
Ordinary Shares in B, Ltd.: 7,000 at 16s. each	5,600			
Ordinary Shares in C, Ltd.: 3,000 at £2 each	6,000			
Preference Shares in C, Ltd.: 3,000 at £1 each	3,000			
Debentures in A, Ltd.: 2,000 at 90%	1,800			
A, Ltd., Loan			3,000	
Ordinary Shares in H, Ltd.: 2,000 at £1 each		2,000		
Ordinary Shares in B, Ltd.: 2,000 at 17s. each				1 700
Profit and Loss Account			1,000	
	£30,000	£33,000	£16,000	£15,000

The calculations are—

$$H = 4{,}500 + \tfrac{4}{5}A + \tfrac{3}{4}B$$
$$A = 4{,}250 + \tfrac{1}{10}B$$
$$B = 1{,}100 + \tfrac{1}{10}H$$

The results will be [to nearest £]—

H = £9,611
A = £4,456
B = £2,061

Illustration. *Where there are " cross " holdings as to both ordinary and preference shares.*

From the Balance Sheets on page 1084, prepare Consolidated Balance Sheet of H, Ltd., and its subsidiaries on 31st December, 19... The preference shares are preferential as to capital in a winding-up. All profits and losses have arisen subsequent to the purchases of the "cross" holdings. The shares are shown in the Balance Sheets at cost The preference dividends may be ignored.

CONSOLIDATED BALANCE SHEET OF H, LTD., AND ITS SUBSIDIARIES, AS AT 31ST DECEMBER, 19..

		£	£		£	£
Share Capital		20,000		Sundry Assets		63,900
Less Shares held by A, Ltd.		2,000		Goodwill	4,000	
			18,000	*Less* Capital Reserve	1,700	
Debenture Reserve			200			2,300
Profit and Loss Account—						
H, Ltd., Profit		4,956				
A, Ltd., Profit		3,044				
C, Ltd., Profit		2,100				
		10,100				
Less B, Ltd., Loss		700				
			9,400			
Debentures			8,000			
Minority Shareholders—						
Preference Shares:						
A, Ltd.		5,000				
C, Ltd.		3,000				
Ordinary Shares:						
B, Ltd.	£1,000					
Less proportion of Loss	100					
		900				
Ordinary Shares:						
C, Ltd.	£1,000					
Add proportion of Profit	700					
		1,700				
			10,600			
Creditors			20,000			
			£66,200			£66,200

GOODWILL

	H, Ltd.	A, Ltd.	B, Ltd.	C, Ltd.	Total
	£	£	£	£	£
Cost of Shares	1,700	6,000	5,600	6,000	19,300
Nominal Value of Shares	2,000	5,000	7,000	3,000	17,000
	– £300	+ £1,000	– £1,400	+ £3,000	+ £2,300

Allocation of Profits

	H, Ltd.	A, Ltd.	B, Ltd.	C, Ltd.
	£	£	£	£
Balances per accounts	6,000	2,000	− 1,000	3,000
Less $\frac{1}{5}$ of £1,000 to C			− 200	− 200
Add $\frac{1}{10}$ of £10,444		1,044		
Less $\frac{1}{10}$ of £10,444[1]	1,044		− 800	2,800
Balances, H, Ltd.'s Interest therein	£4,956	£3,044	[2] − 700	2,100
Proportion attributable to Minority Shareholders			[3] − £100	£700

If the shares were mutually purchased *after* the profits and losses of the subsidiaries shown above, i.e. the purchase prices included such profits and losses, the present net assets purchased would be precisely as they stand in the above Consolidated Balance Sheet. Consequently the net assets when acquired would be less by £3,400, i.e. profit £9,400 less the Profit and Loss Account (credit balance) of H, Ltd., £6,000. Therefore, the cost of control £2,300 becomes capital reserve £1,100 calculated as follows—

		£
A, Ltd., Profits		2,000
C, Ltd., Profits		3,000
		5,000
Less B, Ltd., Loss		1,000
Net Profits		4,000
Less proportion attributable to Minority Shareholders—	£	
C, Ltd., Profit	700	
Less B, Ltd., Loss	100	
		600
Increase of Net Assets acquired		3,400
As against Goodwill on basis of purchase of Assets *before* above results		2,300
Capital Reserve		£1,100

[See page 1087 for Consolidated Balance Sheet]

[1] $\frac{1}{10}$ of £(6,000 + 2,100 + 3,044 − 700) = $\frac{1}{10}$ of £10,444.

The calculations are—

$H = 6{,}000 + A + \frac{7}{10}B + \frac{3}{4}C$ $A = 2{,}000 + \frac{1}{10}H$ $B = -1{,}000$ $C = 3{,}000 + \frac{1}{5}B$.

$\therefore H = £10{,}444$ $A = £3{,}044$ $B = -£1{,}000$ $C = £2{,}800$.

[2] $\frac{1}{4}$ of £2,800.   [3] $\frac{1}{10}$ of − £1,000.

CONSOLIDATED BALANCE SHEET OF H, LTD., AND ITS SUBSIDIARIES, AS AT 31ST DECEMBER, 19..

		£		£
Share Capital		18,000	Sundry Assets	63,900
Debenture Reserve		200		
Capital Reserve [see p. 1086]		1,100		
Profit and Loss Account		6,000		
Debentures		8,000		
Minority Shareholders—	£			
Preference Shareholders: A, Ltd.	5,000			
C, Ltd.	3,000			
Ordinary Shareholders: B, Ltd.	900			
C, Ltd.	[1]1,700			
		10,600		
Creditors		20,000		
		£63,900		£63,900

Part-sale of Holding in Subsidiary. When H disposes of part of its holding in S and the holding/subsidiary company relationship continues, the usual principles will be followed, but consideration must be given to the particular circumstances of each individual case.

Illustration. From the following abridged Balance Sheets and information, prepare draft Consolidated Balance Sheet. Ignore Tax.

BALANCE SHEETS AS AT 31ST DECEMBER, 19..

	H		S			H	S
		£		£		£	£
Share Capital— £1 fully paid		20,000		5,000	Sundry Assets	23,000	9,050
Reserve		2,000		500	Shares in S at cost— 3,000 at 40s.	6,000	
Profit and Loss— At 1st Jan., 19	£3,000		£1,000				
Profit for Year	800		800				
			1,800				
Dividend from S.	200	4,000					
Less Dividend			250	1,550			
Creditors		3,000		2,000			
		£29,000		£9,050		£29,000	£9,050

H had acquired 4,000 shares in S at £2 per share on the 1st January, 19.., and sold 1,000 of them at the same price on the 1st October, 19... On the 1st July, 19.., an interim dividend of 5 per cent was paid by S.

[1] The chief point of importance is that the minority interest in the equity of C, Ltd., is 1,000 ordinary shares [i.e. $\frac{1}{4}$]; but as the company owns one-fifth of the equity of B, Ltd., there is a decrease in the value of the minority interest to the extent of $\frac{1}{4}$ of $\frac{1}{5}$ of the £1,000 loss, viz. £50. Hence the total equity of the minority ordinary shareholders of C, Ltd., is as follows—

	£
$\frac{1}{4} \times$ £(4,000 + 3,000)	1,750
Less $\frac{1}{4} \times \frac{1}{5} \times$ £1,000	50
	£1,700

CONSOLIDATED BALANCE SHEET

	H	S	Adjustments	Total		H	S	Adjustments	Total
	£	£	£	£		£	£	£	£
Share Capital	20,000	5,000	− 5,000	20,000	Sundry Assets	23,000	9,050		32,050
Reserve	2,000	500	− 500	2,000	Shares in S	6,000		− 3,900 − 2,100	
P. & L. Balance	3,000	1,000	− 1,000	3,000					
Profit, etc., for Year	1,000	550	− 220	1,330	Goodwill			+ 2,100	2,100
Creditors	3,000	2,000		5,000					
Minority Interest			+ 2,820	2,820					
[See note (a)]	£29,000	£9,050	−£3,900	£34,150		£29,000	£9,050	−£3,900	£34,150

It is assumed (from the treatment of the dividend in the books of H) that the interim dividend was paid out of profits for the year to 31st December, 19...

The only effect of the holding of the 1,000 additional shares for a part of the year is that H receives a greater proportion of the interim dividend than it would otherwise have done. When H bought the 4,000 shares for £8,000, the position was—

	£	£
Cost of Shares		8,000
Share Capital of S	5,000	
Reserve	500	
Profit and Loss Account	1,000	
	£6,500 80% acquired =	5,200
Goodwill (or Cost of Control)		2,800
As ¼ of the holding has been sold and the shares comprising it carry with them their share of the Goodwill, the deduction to be made is		700
Per Consolidated Balance Sheet above		£2,100

Note (a). Minority Interest is $\frac{2}{5}$ × £(5,000 + 500 + 1,000 + 550) £2,820

Unless it is indicated that special circumstances apply, the procedure to be followed is to assume that the sale is accompanied by the same circumstances as if H had no controlling interest. A sale, therefore, on 1st October would be cum div. and consequently there would be no apportionment of the profits of S to date of sale, with the result that H would get no benefit from the holding of the 1,000 shares beyond the interim dividend paid before the date of sale.

If the dividend was paid out of the opening balance of Profit and Loss Account, £200 would be deducted from the cost of the shares and deleted from H's Profit and Loss Account with consequent reduction in Goodwill and re-allocation of the profit for the year.

It might well be that the whole of the shares were sold to one buyer, in which case H (particularly as it controls S) might stipulate for some other arrangement regarding retention of a portion of the

profits for the year to 31st December, 19. ., attachable to the holding of the 1,000 shares, e.g. H to have four-fifths of the profits to the date of sale and three-fifths thereafter.

If the thousand shares had been sold at 35s. each, involving a loss of 5s. a share, the loss of £250 might be added to Cost of Control (but not Goodwill), as the book value of the holding would be £6,250. On the other hand, H might make the necessary adjustments in its books. If the latter decided to write down its holding by £250, the Consolidated Balance Sheet would be as before, as far as Goodwill or Cost of Control is concerned. From the accounting point of view the prudent course would be for H to make a provision for Subsidiary Company Investment Loss, leaving the investment in its books at £6,250 and showing in the Consolidated Balance Sheet, Goodwill or Cost of Control £2,350 (£2,100 as before plus £250) less Provision £250.

Illustration. From the following skeleton balance sheets and information, prepare Consolidated Balance Sheet.

BALANCE SHEETS AS AT 31ST DECEMBER, 19. .

	H	S		H	S
	£	£		£	£
Share Capital	5,000	1,000	Sundry Assets	4,650	1,600
Investment Reserve	150		Shares in S—		
Profit and Loss:			600 at Cost	900	
At 1st Jan., 19. .	300	360			
Profit for Year	100	240			
	£5,550	£1,600		£5,550	£1,600

H bought 800 shares in S at 30s. per share when the Profit and Loss Account of the latter stood at £220, and sold 200 of them on 30th June, 19. ., at 45s. per share, crediting the 15s. per share profit on sale to an Investment Reserve.

CONSOLIDATED BALANCE SHEET

	H	S	Adjustments	Total		H	S	Adjustments	Total
	£	£	£	£		£	£	£	£
Share Capital £1 f.p.	5,000	1,000	– 1,000	5,000	Sundry Assets	4,650	1,600		6,250
Inv. Reserve	150			150	Shares in S	900		– 732[4]	168[5]
Profit and Loss—									
Balance	300	360	– 276[1]	384					
Profit for Year	100	240	– 96[2]	244					
Minority Interest			+ 640[3]	640					
	£5,550	£1,600	– £732	£6,418		£5,550	£1,600	– £732	£6,418

[1] M.I. $\frac{2}{5} \times$ £360 = £144; H $\frac{3}{5} \times$ £220 = £132 against cost of shares.
[2] M.I. $\frac{2}{5} \times$ £240 = £96.
[3] Share Capital £400 + [1]£144 + [2]£96.
[4] Share Capital £600 + [1]£132.
[5] Goodwill.

Alternatively, the position may be shown in detail as follows, allowing the present Consolidated Balance Sheet to be linked up with the previous one—

CONSOLIDATED BALANCE SHEET

	£	£	£
Share Capital			5,000
Capital Reserve—			
Pre-acquisition Profit		220	
Less Minority Interest ⅕		44	
Deducted *contra*		£176	
Investment Reserve (see 4 below)			150
Profit and Loss Account—			
H Balance, 1st Jan., 19..		300	
Profit for Year		100	
		400	
S Balance, 1st Jan., 19..	360		
Less to Capital Reserve	220		
	140		
Profit to 30th June, 19..	120		
	260		
Less Minority Interest—			
Original ⅕ £52			
New (*re* Sale) ⅕ 52	104		
		156	
Profit to 31st Dec., 19..	120		
Less Minority Interest ⅖	48		
		72	
			628
Minority Interest—			
Share Capital		400	
Capital Reserve ⅕		44	
Do. Sale from Goodwill *contra*		44	
Profit and Loss Account		152	
			640
			£6,418

	£	£	£
Sundry Assets—			
H		4,650	
S		1,600	
			6,250
Goodwill at cost—			
Cost of 800 Shares		1,200	
Less Share Capital	800		
„ Capital Reserve	176		
		976	
		224	
Deduct applicable to 200 Shares sold—			
Sale Price	450		
Less Investment Reserve	150		
	300		
Less Share Capital £200, ¼ Original Capital Reserve to Minority Interest *contra* 44	244		
		56	
			168
			£6,418

Notes. (1) Assumed that the profit of S was earned evenly during the year.

(2) The Goodwill figures are taken to be in respect of ordinary Goodwill, for which there is no account in the books of S—that is to say, that no account is taken of any amount paid by H on the original purchase for an 80 per cent control, nor of any amount received by H on the subsequent sale for relinquishing its 75 per cent majority.

(3) Apart from the considerations in (2), Goodwill is shown at cost (in respect of 800 shares) *less* ¼ (in respect of 200 shares sold). It is apparent from the price of the sale on 30th June that the value of Goodwill has considerably increased. Goodwill might therefore be written up to its new valuation, in order to show the correct figure, with consequent adjustments on the liabilities side to the interest of H and the minority shareholders. It is, however, the usual practice to show Goodwill at cost and not to revalue it.

(4) The Investment Reserve of £150 is made up of £52 in respect of profits of S applicable to 200 shares sold, from the date of purchase to date of sale (this figure is shown in the Consolidated Balance Sheet as being transferred out of Profit and Loss Account to Minority Interest), and £98 received in respect of additional Goodwill. If Goodwill were revalued as indicated in (3) above, this £98 would be dealt with in the revaluation. If no revaluation is made, it is considered better not to deduct it from the Goodwill figure in the Consolidated Balance Sheet, since, if that were done, a secret reserve would be created.

Journal Entries. The tendency in professional examinations is towards intricate and detailed problems in Holding Company accounts and, therefore, a candidate must be able to avoid confusion in preparing the Consolidated Balance Sheet. For this reason, the method of adjustment by means of additions, subtractions and contras is not recommended except in the simpler problems. The most satisfactory method is that using columns for the balance sheet figures of each of the constituent companies with a column for the preliminary aggregation of those figures, followed, on each side of the balance sheet, by three columns for (*a*) debit adjustments, (*b*) credit adjustments and (*c*) final aggregation respectively. In very complicated cases it will often be necessary to write up the adjustment columns from a set of journal entries. Since the aggregation columns are merely a matter of copy-work or of addition and subtraction, it is contended that the presentation of the correct journal entries will earn a very large proportion of the marks allotted to the question, and in fact the formal copy-work, etc., will take time out of all proportion to the number of marks it can possibly earn.

Illustration. From the Balance Sheets and information given below, prepare Consolidated Balance Sheet, showing journal entries for the adjustments.

BALANCE SHEETS AS AT 31ST DECEMBER, 19..

	Great, Ltd.	Medium, Ltd.	Small, Ltd.
	£	£	£
Share Capital: £1 fully paid	100,000	50,000	20,000
Reserve	20,000	6,000	
Profit and Loss	10,000	10,000	
Debentures	40,000		
Creditors	4,000	8,000	5,000
Bills Payable			1,000
Loan from Medium			2,000
Loan from Small	1,500		
Provision *re* Subsidiaries	1,500		
	£177,000	£74,000	£28,000
Sundry Fixed Assets	97,300	30,400	9,200
Goodwill		15,000	
Shares at cost—			
Medium, 40,000	46,000		
Small, 20,000	17,000		
Debentures at cost: Great, £10,000		9,500	
Stock	9,000	9,000	11,000
Debtors and Cash	7,000	7,000	2,300
Bills Receivable	700		
Loan to Great			1,500
Loan to Small		2,000	
Development Expenditure		1,100	
Profit and Loss			4,000
	£177,000	£74,000	£28,000

(1) The shares in Medium were acquired some years previously when the Reserve and Profit and Loss Account of that company stood at £6,000 and £5,500 respectively.

(2) The shares in Small were acquired at the date of the above Balance Sheets, the price being adjusted so as to take into account the fact that the fixed assets of that company were worth £2,500 more than book value.

(3) The Bills Payable in the Balance Sheet of Small had all been issued to Great, and there was a note in the latter's Balance Sheet of a contingent liability of £300 in respect of bills discounted.

(4) The provision *re* subsidiaries in the Balance Sheet of Great arose in respect of—

(*a*) £1,100 for unrealized profit on goods costing Great £3,900 which had been sold to Small for £5,000 at which figure they were included in the latter's Balance Sheet, none having been sold.

(*b*) £400 in respect of Development Expenditure of Medium to be written off.

(5) The debentures of Great appearing in the Balance Sheet of Medium had been purchased in the open market.

JOURNAL

		£	£
Share Capital of Medium	*Dr.*	50,000	
To Shares in Medium .			40,000
,, Minority Interest . . .			10,000
Allocation of share capital of Medium between Great and outside shareholders.			
Goodwill . . .	*Dr*	6,000	
To Shares in Medium .			6,000
Excess of cost of shares over nominal value			
Share Capital of Small	*Dr.*	20,000	
To Shares in Small			17,000
,, Capital Reserve . .			3,000
Excess of nominal value of shares of Small (all held by Great) over cost.			
Reserve of Medium . . .	*Dr.*	6,000	
Profit and Loss of Medium . .	*Dr*	5,500	
To Capital Reserve . . .			9,200
,, Minority Interest. . .			2,300
Allocation of pre-acquisition reserve and profit and loss balance between Great and outside shareholders in ratio of 4 . 1.			
Debentures of Great	*Dr*	10,000	
To Debentures in Great . . .			9,500
,, Capital Reserve . . .			400
,, Minority Interest . . .			100
Elimination of inter-company holding and allocation of "profit" between Great and outside shareholders			

JOURNAL (*contd.*)

		£	£
Bills Payable (Small)	*Dr.*	700	
To Bills Receivable (Great) . . .			700
Elimination of inter-company holding.			
Loan from Medium	*Dr.*	2,000	
Loan from Small	*Dr.*	1,500	
To Loan to Small			2,000
,, Loan to Great			1,500
Elimination of inter-company loans.			
Provision *re* Subsidiaries	*Dr.*	1,500	
Minority Interest	*Dr.*	100	
To Stock.			1,100
,, Development Expenditure			500
Elimination of unrealized profit from Stock and writing off of Development expenditure. (*Note.* Since Great provided £400, it is assumed that £500 is to be written off, outside shareholders bearing their one-fifth proportion.)			
Sundry Fixed Assets	*Dr.*	2,500	
To Capital Reserve			2,500
Unrecorded undervaluation of assets of Small taken into account in fixing price of shares.			
Goodwill	*Dr.*	4,000	
To Profit and Loss Account of Small . .			4,000
Debit balance at date of acquisition.			
Profit and Loss Account of Medium . .	*Dr.*	900	
To Minority Interest.			900
One-fifth share of post-acquisition profits (£10,000 − £5,500).			
Capital Reserve	*Dr.*	10 000	
To Goodwill			10,000
Elimination of items added to Goodwill in above entries against Capital Reserve.			

Note. The balance of Capital Reserve, which is £5,100, might also be used to write down the Goodwill figure of Medium to £9,900.

Summary of Goodwill and Capital Reserve from above entries.

GOODWILL

	£	£
Per Balance Sheet of Medium		15,000
Add re Medium (excess over par of cost) . .	6,000	
,, Small (pre-acquisition loss) . . .	4,000	
		10,000
		25,000
Less Transfer from Capital Reserve		10,000
Per Consolidated Balance Sheet.		£15,000

CONSOLIDATED BALANCE SHEET OF GREAT, LTD., AND ITS SUBSIDIARIES AS AT 31ST DECEMBER, 19

	Great, Ltd	Medium Ltd	Small, Ltd	Total	Adjustments Dr	Adjustments Cr	Total
	£	£	£	£	£	£	£
Share Capital	100,000	50,000	20,000	170,000	50,000 20,000		100 000
Reserve	20,000	6,000		26,000	6,000		20,000
Profit and Loss	10,000	10,000		20,000	5,500 900		13 600
Debentures	40 000			40,000	10,000		30,000
Creditors	4,000	8,000	5,000	17 000			17,000
Bills Payable			1,000	1,000	700		300
Loan from Medium			2,000	2 000	2 000		
Loan from Small	1,500			1,500	1 500		
Provision re Subsidiaries	1,500			1,500	1,500		
Capital Reserve					10,000	3 000 9,200 400 2,500	5,100
Minority Interest					100	10 000 2,300 100 900	13,200
	£177,000	£74,000	£28,000	£279,000	£108,200	£28,400	£199,200
					£79,800		

	Great, Ltd	Medium Ltd	Small, Ltd	Total	Adjustments Dr	Adjustments Cr.	Total
	£	£	£	£	£	£	£
Sundry Fixed Assets	97,300	30,400	9,200	136,900	2,500 6,000		139,400
Goodwill		15,000		15,000	4,000	10,000	15,000
Shares in Medium	46,000			46,000		40,000 6,000	
Shares in Small	17,000			17,000		17,000	
Debentures in Great		9,500		9,500		9,500	
Stock	9,000	9,000	11,000	29,000		1,100	27,900
Debtors and Cash	7,000	7,000	2,300	16,300			16,300
Bills Receivable	700			700		700	
Loan to Great			1,500	1,500		1,500	
Loan to Small		2,000		2,000		2,000	
Development Expenditure		1,100		1,100		500	600
Profit and Loss			4,000	4,000		4,000	
	£177,000	£74,000	£28,000	£279,000	£12,500	£92,300	£199,200
					£79,800		

CAPITAL RESERVE

	£	£
Re Medium (pre-acquisition profits)	9,200	
,, Small (excess of par over cost)	3,000	
,, Debentures of Great	400	
,, Sundry Fixed Assets of Small	2,500	
		15,100
Less Transfer to Goodwill		10,000
Per Consolidated Balance Sheet		£5,100

CONSOLIDATED PROFIT AND LOSS ADJUSTMENTS

After aggregating the various debits and credits of the constituent companies' Profit and Loss and Appropriation Accounts under their appropriate headings, adjustments will be required, of which the following are the most important—

(1) The transfer of profit or loss of subsidiaries attributable to the Holding Company's shares applicable to the period prior to acquisition of such shares, the transfer being to the credit of the cost of the shares for profit or to the debit thereof for loss, the net effect of which is to decrease Goodwill or increase Capital Reserve in the case of profit, or conversely for loss.

(2) The transfer to the credit of Minority Shareholders in respect of the proportion of the subsidiaries' profits attributable to them; or to the debit in case of loss. As already indicated in this chapter, the Minority Shareholders cannot legally become liable to the Holding Company for such share of loss, not even if such share of loss exceeds their paid-up capital, owing to the principle of limited liability, so that the most favoured opinion is that such sum should be featured as a contingent asset (analagous to Short Workings in Royalty Accounts) or deducted from the Reserves or Share Capital of the Holding Company, being, of course, clearly described in the Consolidated Balance Sheet.

(3) The elimination of internal items, e.g. dividends and interest arising within the Group. If the Holding Company has already passed through its books its proportion of the proposed dividends from subsidiaries, there will be a cancellation of both sides of the Consolidated Profit and Loss Account, and similarly in the Consolidated Balance Sheet for such proposed dividends receivable and payable. The remaining parts of the proposed dividends will be transferred to the credit of Minority Shareholders.

If such proposed dividends have not been dealt with in the books of the Holding Company, a cancellation will be made by reducing the dividends debit in the Consolidated Profit and Loss Account and the Proposed Dividends item on the liabilities side of the Consolidated Balance Sheet. [Alternatively, the unentered Dividends Receivable may be introduced as an asset and as a profit (as if the

Holding Company had actually entered them in its books and then cancelled them)].

(4) The adjustment of Income Tax in respect of Dividends and Interest will have to be made where required. As regards Dividends, these will be "net," i.e. after deduction of Income Tax in the books of the paying Subsidiaries and (probably) gross in the books of the Holding Company (after having debited the Income Tax thereon to Income Tax and crediting the "net" dividend to bring it up to gross), so that an adjusting entry is required to reverse the above transfer, so as to restore the gross dividends received to "net." Hence there will be a debit to Dividends Received and a credit to Income Tax in the Consolidated Profit and Loss Account, but none will be required in the Consolidated Balance Sheet, as both the Dividends Receivable and Proposed will be shown there "net" (or if it relates to dividends already paid by the subsidiaries, the item, as such, will not appear in the Consolidated Balance Sheet). Where the Holding Company has not entered in its books the proposed dividends, no adjustment is required in respect of Income Tax therefor, unless the proposed Dividend has been entered and cancelled as in (3).

As regards interest, e.g. Debenture Interest, both the receiving and the paying companies will have entered the item in their respective books on a gross basis (after transferring the relevant Income Tax thereon to Income Tax), so that there will be an elimination of both the gross interest debited and the gross interest credited, no adjustment being required for Income Tax because the same amount of Income Tax has been debited (by the receiving company) and credited (by the paying company).

If the interest has not been paid, the debtor company will have already charged the accrual gross to its Profit and Loss Account and credited a liability for the "net" sum payable, and credited Income Tax with the Income Tax thereon. If the receiving company has brought such interest into its books, there will be an eliminating transfer of both "net" payable and receivable sums in the Consolidated Balance Sheet, but no adjustment for Income Tax, assuming that the receiving company had dealt correctly with the sum receivable by debiting the "net" interest as an asset and debiting Income Tax with the Income Tax thereon and crediting Profit and Loss with the gross amount.

If the receiving company has *not* brought such interest into its books, it can be brought in and taken out (as mentioned in connection with dividends) "net," or the "net" liability in the Consolidated Balance Sheet can be debited and the interest charged in the Consolidated Profit and Loss Account credited, the Income Tax thereon being debited to Income Tax and interest account credited. In other words, there will be a credit to interest charged of the gross sum, and (i) a debit to Income Tax (both in the Consolidated Profit and Loss Account) and (ii) a debit to the liability for the "net" interest payable in the Consolidated Balance Sheet.

(5) Where the Holding Company has taken up the whole of its proportion of the PROFITS of the subsidiaries, this will require elimination, as the total Group profit is already in the Consolidated Profit and Loss Account.

(6) Transfers of goods within the group will require eliminating from the sales and purchases side of the Consolidated Profit and Loss Account (although the sales and purchases items will not appear in the *published* accounts).

(7) Any profit on sales made by one member of the group to the other is not true profit, except where realized, so that the profit on the unsold goods will require eliminating. This is required whether it is the Holding Company that sells to a subsidiary or *vice versa*, the elimination being the cost price of the goods remaining unsold (from the asset in the Consolidated Balance Sheet and from the Trading Profit in the Consolidated Profit and Loss Account), the difference being the profit on sale representing the proportion attributable to the Minority Shareholders, the profit remaining to the Holding Company where the sale is by it to a subsidiary, but the profit remaining in respect of a sale from the subsidiary to the Holding Company enures to the benefit of the Minority Shareholders. Many accountants consider that even where there is a Minority Interest the whole of the cost should be eliminated as the "paper" profit is wholly artificial. Goods bought by a member and resold to another member (both at a profit) and remaining unsold should not carry any profit at all.

(8) Where a fixed asset is sold at a profit or loss by a member of a group to another member, the position is similar to that in (7). It is generally agreed that the adjustments required are such as to restore the position in the accounts as if the sale had not been made, and this will involve, not only the cancellation of the profit or loss on the transfer, but the amendment of the depreciation charge if it has been based on the *transfer* value.

(9) Where there are foreign subsidiaries, adjustments may be required to deal with any special factors in foreign taxes, particularly where a special tax is levied on distributed dividends, including tax on distributions to non-resident holders.

(10) Where a subsidiary is acquired at a time when there are arrears of cumulative preference dividends, such arrears may be dealt with—

(*a*) By way of "note" only, no accounting entries being made in the Consolidated Accounts, but when such arrears are paid they must be treated, as far as possible, as arising out of pre-acquisition reserves of the subsidiary and, if the latter are not sufficient, from the post-acquisition profit of the subsidiary; or

(*b*) By accounting entries in the Consolidated Accounts to bring the arrears, less income tax, into liability to Minority Shareholders and as an addition to Goodwill or deduction from Capital Reserve. When the arrears are paid, they will be dealt

with as in (*a*), that is, out of pre-acquisition reserves of the subsidiary, as far as possible and, if not sufficient, from the post-acquisition profit of the subsidiary and applied to reduce the goodwill item or decrease the Capital Reserve item.

Where some of the Preference shares of the subsidiary have been acquired by the Holding Company, the same rule will apply to the remainder *not acquired.*

(11) Where a Holding Company writes off the whole or part of the cost of the shares acquired in a subsidiary, the write-off should be cancelled (thus increasing the profit and likewise increasing goodwill (or decreasing Capital Reserve); or it may remain undisturbed, but the amount of profit so applied must be disclosed in the Consolidated Accounts.

Illustration. H holds 6,000 shares and £3,200 Debentures of S, the dates of acquisition being 1st March, 1953, and 1st January, 1953, respectively. All the shares are of 10s. each, fully paid. The cost price of the shares was 14s. per share and the Debentures par.

The accounts relate to the first year of the company. There was an interim dividend declared by S of 10 per cent, followed by a final proposed dividend of 16 per cent, H proposing a dividend of 15 per cent (free of tax).

The abridged final accounts of H and S were as follows—

BALANCE SHEET AS AT 31ST DECEMBER, 1953

	H	S		H	S
	£	£		£	£
Share Capital	10,000	5,000	Sundry Assets	8,992	12,231
Profit and Loss Account	4,000	2,236	Shares in S at cost	4,200	
Debentures (5%)		4,000	Debentures of S at cost	3,200	
Income Tax Provision	1,200	500	Dividend Receivable (from S)	264	
Debenture Interest accrued		55	Debenture Interest Receivable	44	
Proposed Dividend	1,500	440			
	£16,700	£12,231		£16,700	£12,231

PROFIT AND LOSS ACCOUNT

Dr. FOR THE YEAR ENDED 31ST DECEMBER, 1953 *Cr.*

	H	S		H	S
	£	£		£	£
To Directors' Remuneration	2,000	500	By Trading Profit	8,183	4,061
,, Debenture Interest		200	,, Debenture Interest	160	
,, Net Profit c/d	7,123	3,361	,, Dividends	780	
	£9,123	£4,061		£9,123	£4,061
To Income Tax	1,623	410	By Net Profit b/d	7,123	3,361
,, Dividend paid, net		275			
,, Proposed Dividend, net	1,500	440			
,, Balance to Balance Sheet	4,000	2,236			
	£7,123	£3,361		£7,123	£3,361

Prepare Consolidated Balance Sheet and Consolidated Profit and Loss Account. Ignore Profits Tax.

	Aggregate of H & S	Adjustments Dr.	Adjustments Cr.	Total
	£	£	£	£
Share Capital	15,000	3,000		
		2,000		10,000
Profit and Loss Account	6,236	1,230		5,006
Income Tax Provision	1,700			1,700
Debentures (5%)	4,000	3,200		800
Debenture Interest accrued	55	44		11
Proposed Dividend	1,940	264		
		176		1,500
Minority Interest—				
Share Capital of S			2,000	
Proposed Dividend of S			176	
Profit for Year of S (⅖ × £2,236)			894	3,070
	£28,931	9,914	£3,070	£22,087
		3,070		
		£6,844		

	Aggregate of H & S	Adjustments Dr.	Adjustments Cr.	Total
	£	£	£	£
Sundry Assets	21,223			21,223
Shares in S	4,200		3,000	
			336	
			864	
Debentures of S	3,200		3,200	
Dividend Receivable	264		264	
Debenture Interest Receivable	44		44	
Goodwill		864		864
	£28,931	£864	7,708	£22,087
			864	
			£6,844	

Notes. (1) The proportion of profit accruing at 1st March, 1953, is ⅙ × ⅗ × £3,361, equals $\frac{1}{10}$ of £3,361. Strictly, the relevant portion of Income Tax (£410) should be deducted from the £3,361; but as this figure is obviously an estimated (and probably inadequate) one, the adjustment has been made on the profit of £3,361.

Consolidated Profit and Loss Account for the Year ended 31st December, 1953

	Aggregate of H & S	Adjustments Dr.	Adjustments Cr.	Total
	£	£	£	£
To Directors' Remuneration	2,500			2,500
,, Debenture Interest	200		160	40
,, Net Profit c/d	10,484		780	9,704
	£13,184		£940	£12,244
,, Income Tax	2,033		351	1,682
,, Dividend Paid	275		165	
			110	
,, Dividend Proposed	1,940		264	1,500
			176	
,, Pre-acquisition Profit accruing at date of acquisition of S Shares attributable to H		336		336
Dividends Paid and Proposed to Minority Interest		110		
		176		286
,, Balance of Profit of S attributable to Minority Interest		894		894
,, Balance to Balance Sheet	6,236		1,230	5,006
	£10,484	1,516	2,296	£9,704
			1,516	
			£780	

	Aggregate of H & S	Adjustments Dr.	Adjustments Cr.	Total
	£	£	£	£
By Trading Profit	12,244			12,244
,, Debenture Interest	160	160		
,, Dividends	780	351		
		165		
		264		
	£13,184	£940		£12,244
,, Net Profit b/d	10,484	780		9,704
	£10,484	780	—	£9,704
		—		
		£780		

Notes (contd). (2) All the items of internals are on a uniform basis, except the dividend receivable by H, which is gross, so that this item (£780) must be reduced to net by a transfer out (to credit of Income Tax, which includes the Income Tax suffered by H on the dividends paid and accruing to it, viz. £351). The others present no difficulty.

(3) The Tax provision is £1,700, but the charge to Revenue is £1,682, the difference of £18 being tax at 9s. in the £ on the Debenture Interest payable to the outside debenture-holders, viz. £800 at 5 per cent, i.e. £40.

Illustration. The following are the abridged final accounts of H and S—

BALANCE SHEET AS AT 31ST DECEMBER, 1952

	H	S		H	S
	£	£		£	£
Share Capital—£1 f.p.	10,000	5,000	Sundry Assets	36,700	7,100
Revenue Reserve	5,000	3,500	Stock	4,000	4,500
Profit and Loss Account	5,000	4,000	Shares in S at cost	6,300	
Creditors	7,000	3,500	H Debentures at cost		6,400
Debentures 4%	20,000	1,000	Discount on Debentures	1,000	
Proposed Dividend	1,000	1,000			
	£48,000	£18,000		£48,000	£18,000

PROFIT AND LOSS ACCOUNT
Dr. FOR THE YEAR ENDED 31ST DECEMBER, 1952 *Cr.*

	H	S		H	S
	£	£		£	£
To Directors' Remuneration	3,000	2,000	By Trading Profit	8,000	9,260
,, Depreciation	1,000	1,500	,, Debenture Interest		280
,, Debenture Interest	800	40	,, Dividend received	800	
,, Net Profit c/d	4,000	6,000			
	£8,800	£9,540		£8,800	£9,540
To Dividends paid	500	1,000	By Balance from last year	2,500	1,500
,, Proposed Dividends	1,000	1,000	,, Net Profit b/d	4,000	6,000
,, Transfer to Reserve		1,500			
,, Balance to Balance Sheet	5,000	4,000			
	£6,500	£7,500		£6,500	£7,500

H holds 4,000 shares in S, bought when the credit balance on the Profit and Loss Account of S was £125 and Revenue Reserves were £2,000. On 1st January, 1952, H issued £20,000 Debentures at a discount of 5 per cent and S was allotted (for cash) £2,000; on 1st March, 1952, S purchased £5,000 of the Debentures of H for £4,500. H has sold goods to S for £500 (cost £450), all of which remain unsold.

Prepare Consolidated Balance Sheet and Consolidated Profit and Loss Account, assuming that all dividends to H are to be regarded as being paid out of current profit of S, ignoring taxation and accruing interest on the Debentures at the date of purchase by S, and assuming that the proposed dividend of S had *not* been brought into the books of H at 31st December, 1952. (See page 1101.)

[1] Goodwill is cost of shares £6,300 less Nominal Capital, £4,000, and proportion of Reserve and Profit and Loss Account at acquisition, £1,600 and £100 respectively.

[2] Discount on Debentures is 5 per cent of £13,000 Debentures of H held outside the Group, i.e. £650, plus the discount applicable to the minority shareholders' proportion of the Debentures held by S, i.e. one-fifth of 5 per cent of £7,000, i.e. £70.

[3] The profit on the £5,000 Debentures bought on 1st March is £500 less £250 dealt with as Discount on Debentures. Of the balance of £250, one-fifth is due to the minority interest.

[4] Profit and Loss Account is made up of H £5,000, plus four-fifths of S (£4,000 less pre-acquisition profits £125) and four-fifths of S's proposed dividend, less four-fifths of H's unrealized profit of £50.

[5] The minority interest is Share Capital £1,000, Reserve £700, Profit and Loss Account £800 (Profit of the year £1,200 plus balance brought forward £300, less included in Reserve £300 and dividends paid and proposed £400), Proposed Dividend £200, Discount on Debentures £70 (see [2] above) and Profit on Debentures £50 (see [1] above). In the Consolidated Profit and Loss Account, the minority interest has been charged in arriving at the net profit of the year applicable to the members of H, so that the position is shown so far as it concerns those members.

	Aggregate of H & S	Adjustments Dr.	Adjustments Cr.	Total
	£	£	£	£
Share Capital £1 f.p.	15,000	(a) 4,000 (b) 1,000		10,000
Revenue Reserve	8,500	(h) 1,600 (i) 700		6,200
Capital Reserve		(j) 50	(c) 250	200[2]
Profit and Loss Account	9,000	(X) **140**		8,860[4]
Debentures (4%)	21,000	(e) 7,000		14,000
Creditors	10,500			10,500
Proposed Dividend	2,000	(s) 800 (c) 200		1,000
Minority Interest			(b) 1,000 (i) 700 (f) 70 (j) 50 (o) 200 (q) **800**	2,820[1]
	£66,000	15,490	£3,070	£53,580
		3,070		
		£12,420		

	Aggregate of H & S	Adjustments Dr.	Adjustments Cr.	Total
	£	£	£	£
Sundry Assets	43,800			43,800
Stock	8,500		(k) **40**	8,460
Shares in S at cost	6,300		(a) 4,000 (h) 1,600 (t) **100** (v) 600[1]	
H Debentures at cost	6,400	(c) 250 (d) 350	(e) 7,000	
Discount on Debentures	1,000	(f) 70	(d) 350	720[2]
Dividend Receivable		(n) **800**	(s) 800	
Goodwill		(v) 600		600[1]
	£66,000	£2,070	14,490	£53,580
			2,070	
			£12,420	

Note. Items in ordinary type are transfers within the Consolidated Balance Sheet; items in heavy type are transfers as between the Consolidated Balance Sheet and Consolidated Profit and Loss Account.

Consolidated Profit and Loss Account of H and S for the Year ended 31st December, 1952

	Aggregate of H & S	Adjustments Dr.	Adjustments Cr.	Total
	£	£	£	£
To Directors' Remuneration	5,000			5,000
,, Depreciation	2,500			2,500
,, Debenture Interest	840		(m) *280*	560
,, Minority Interest		(q) **1,200**		1,200
,, Net Profit c/d applicable to members of H	10,000		(T) *840* (z) *1,200*	7,960
	£18,340	£1,200	2,320	£17,220
			1,200	
			£1,120	
To Transfer to Reserve	1,500		(q) **300**	1,200
,, Dividend paid	1,500		(p) *800*	500
,, Proposed Dividend	2,000		(q) **200** (s) *800*	1,000
,, Balance to Balance Sheet	9,000		(q) **200** (X) **140**	8,860
	£14,000	—	£2,440	£11,560

	Aggregate of H & S	Adjustments Dr.	Adjustments Cr.	Total
	£	£	£	£
By Trading Profit	17,260	(k) **40**		17,220
,, Debenture Interest	280	(m) *280*		
,, Dividend Received	800	(p) *800*		
,, Dividend Receivable		(s) *800*	(n) **800**	
	£18,340	1,920	£800	£17,220
		800		
		£1,120		
By Balance from last year	4,000	(t) **100** (q) **300**		3,600
,, Net Profit b/d	10,000	(T) *840* (z) *1,200*		7,960
	£14,000	£2,440	—	£11,560

Note. Items in italics are transfers within the Consolidated Profit and Loss Account.

ALTERNATIVE METHODS OF PRESENTATION

Once the principles underlying preparation of consolidated accounts are fully understood, no difficulty should arise with the alternative methods allowed in Section 151 of the Companies Act, 1948. It will be remembered that one of these is to present separate consolidated accounts for a particular group of subsidiaries.

Illustration. From the following Balance Sheets prepare Consolidated Balance Sheet of X and Y—

BALANCE SHEETS

	H	X	Y		H	X	Y
	£	£	£		£	£	£
Share Capital .	55,000	20,000	10,000	Sundry Assets .	26,000	36,000	22,000
Profit and Loss .	5,000	12,000	10,000	Shares in—			
Debentures .			5,000	X (15,000) .	20,000		
Creditors—				Y (9,000) .	10,000		
Sundry . . .		1,000	1,000	X Loan . .	4,000		
Y . . .		1,000		Debtors—			
H Loan . .		4,000		Sundry . .		2,000	3,000
				X . . .			1,000
	£60,000	£38,000	£26,000		£60,000	£38,000	£26,000

CONSOLIDATED BALANCE SHEET OF X AND Y, SUBSIDIARIES OF H

	£	£			£
Interest of H—			Sundry Assets .		58,000
Share Capital .	24,000		Sundry Debtors .		5,000
Profit and Loss .	18,000				
Loan (X) . .	4,000				
		46,000			
Minority Interest—					
Share Capital .	6,000				
Profit and Loss .	4,000				
		10,000			
Debentures . .		5,000			
Sundry Creditors .		2,000			
		£63,000			£63,000

The allocation of Capital and Profit is—

		H	M.I.
Share Capital—X:	£20,000	£15,000	£5,000
Y:	10,000	9,000	1,000
		£24,000	£6,000
Profit and Loss—X: . . .	£12,000	£9,000	£3,000
Y: . . .	10,000	9,000	1,000
		£18,000	£4,000

Illustration. From the following details, prepare consolidated accounts. The shares in S were acquired by H on the 1st April prior to the date of the accounts shown on page 1103.

Balance Sheets as at 31st March, 19..

	H	S		H	S
	£	£		£	£
Share Capital: £1 fully paid	5,000	1,600	Sundry Assets	9,684	4,420
Profit and Loss Account	2,000	1,120	Shares in S: 1,200 at Cost	1,850	
Creditors	1,100	612	Dividend Receivable from S, *less* Tax at 9s.	66	
Provision for Taxation	3,500	1,000			
Proposed Dividend, *less* Tax at 9s.		88			
	£11,600	£4,420		£11,600	£4,420

Profit and Loss and Appropriation Accounts for the Year ended 31st March, 19..

Dr. *Cr.*

	H	S		H	S
	£	£		£	£
To Expenses	2,300	1,920	By Trading Profit	4,580	3,428
,, Profit c/d	2,400	1,508	,, Dividend from S (gross)	120	
	£4,700	£3,428		£4,700	£3,428
To Taxation	1,400	1,100	By Balance from previous year	1,000	800
,, Proposed Dividend, *less* Tax		88	,, Profit for Year b/d	2,400	1,508
,, Balance	2,000	1,120			
	£3,400	£2,308		£3,400	£2,308

The accounts are shown on page 1104.

Illustration. From the following figures prepare a Consolidated Profit and Loss Account of a Holding Company for the year 1952—

	Holding Company	Subsidiaries A	Subsidiaries B	Subsidiaries C	Associated Company D
	£	£	£	£	£
Trading Profit, 1952	120,000	18,000	10,200	4,500	92,000
Investment Income	10,000				22,000
Profit on Sale of Buildings				1,000	
Dividends received (on 1951 account)—					
From A.	2,000				
,, B	1,500				
Profits brought forward, 1st January, 1952	15,000	20,000	2,500	200	22,500
	£148,500	£38,000	£12,700	£5,700	£136,500
Depreciation	9,000	1,000	800	800	12,000
Directors' Fees	18,000		2,000	2,000	10,000
Loss on Sale of Investments	15,500				
Debenture Interest	8,500		2,500		3,000
Dividends—					
Ordinary (on 1951 account)	20,000	4,000	1,500		
Preference (Interim, 1952)	7,500			2,000	4,000
Provision for Taxation	52,000	11,000	3,900	650	77,000
Balances	18,000	22,000	2,000	250	30,500
	£148,500	£38,000	£12,700	£5,700	£136,500
Share Capital Issued—					
Ordinary: Total	300,000	80,000	40,000	15,000	100,000
Holding Company shareholding		40,000	40,000	10,000	40,000
Preference (held outside Group)	200,000			80,000	150,000

Consolidated Balance Sheet

	H	S	Adjustment	Total
	£	£	£	£
Share Capital	5,000	1,600	(a) − 1,200 (b) − 400	5,000
Profit and Loss Account	2,000	1,120	(x) − 880	2,240
Creditors	1,100	612		1,712
Taxation	3,500	1,000		4,500
Proposed Dividend		88	(a) − 66 (d) − 22	
Minority Interest—				
Share Capital			(b) + 400	
Dividend			(d) + 22	702[1]
Profit and Loss Account			(j) + 280	
	£11,600	£4,420	− £1 866	£14,154

	H	S	Adjustment	Total
	£	£	£	£
Sundry Assets	9,684	4,420		14,104
Shares in S	1,850		(a) − 1,200 (e) − 650	
Dividend	66		(c) − 66	
Goodwill			(e) + 650 (f) − 600	50
	£11,600	£4,420	− £1,866	£14,154

Dr. Consolidated Profit and Loss and Appropriation Accounts *Cr.*

	H	S	Adjustments	Total
	£	£	£	£
To Expenses	2,300	1,920		4,220
" Profit	2,400	1,508	(g) − 120	3,788
	£4,700	£3,428	− £120	£8,008
To Taxation	1,400	1,100	(i) − 54	2,446
" Dividends		88	(h) − 66	22
" Balance—				
H	2,000	1,120	(f) − 600 (j) − 280 (x)	2,240
M.I.			(j) + 280	280
	£3,400	£2,308	− £720	£4,988

	H	S	Adjustments	Total
	£	£	£	£
By Trading Profit	4,580	3,428		8,008
" Dividend	120		(h) − 66 (i) − 54	
	£4,700	£3,428	− £120	£8,008
By Balance from previous Year	1,000	800	(f) − 600	1,200
" Profit for Year	2,400	1,508	(g) − 120	3,788
	£3,400	£2,308	− £720	£4,988

[1] The equity of minority shareholders is—

	£	£
Share Capital of S		1,600
P. and L. Balance of S		800
Profit for Year	1,508	
Less Taxation	1,100	408
		£2 808
		£702

or

	£
Share Capital of S	1,600
Profit and Loss of S	1,120
	£2,720
¼ thereof	680
Dividend ¼ × £88	22
	£702

Consolidated Profit and Loss Account of Holding Company and Its Subsidiaries for the Year 1952

Dr.	£	£	*Cr.*	£	£
To Depreciation . . .		11,600	By Trading Profit . .		152,700
,, Directors' Fees . .		22,000	,, Investment Income .		10,000
,, Loss on Sale of Investments . . .		15,500	,, Profit on Sale of Buildings		1,000
,, Debenture Interest .		11,000			
,, Provision for Taxation .		67,550			
,, Combined Net Profit for Year c/d . . .		36,050			
		£163,700			£163,700
To Dividends for 1952 payable by Holding Company—			By Net Profit b/d . .		36,050
Preference:			*Less* Outside Shareholders—		
Interim paid . .	7,500		Int. 1952 Pref. Div. C paid . . .	2,000	
Final not yet paid .	7,500		Undistributed Profit for Year . . .	3,050[1]	
		15,000			5,050
Proposed Ordinary .		?			31,000
,, Balance of Undistributed Profits—					
Holding Company .	10,500[4]		,, Balance from 1951 . .	37,700	
Interest of Holding Company in Subsidiaries . . .	13,000[3]		*Less* 1951 Ordinary Dividends paid to outside Shareholders—		
		23,500	A . . £2,000		
			Holding Co. 20,000		
				22,000	
				15,700	
			Less Minority Interest in undistributed Balance . £10,200		
			Less Dividend paid by A 2,000		
				8,200[2]	
					7,500
		£38,500			£38,500

Notes—

(1) The allocation of undistributed profits is—

		A		B	C		Minority Shareholders	Holding Company
		£	£	£	£			
Balance per Accounts		22,000		2,000	250			
Less brought forward	£20,000		2,500		200			
,, Ord. Div., 1951	4,000		1,500					
		16,000		1,000				
		6,000		1,000	50		£	£
Minority Shareholders		3,000		—	50	=	3,050[1]	
Holding Company		£3,000		£1,000	—	=		4,000
Balances forward as above . . .		16,000		1,000	200			
Minority Shareholders		8,000		—	200	=	8,200[2]	
Holding Company		£8,000		£1,000	—	=		9,000
							£11,250	£13,000[3]
							£24,250[5]	

The total profit balances (per accounts) are—

	£	
H.	18,000	
Less Pref. Div. unpaid.	7,500	
		£10,500[4]
A.	22,000	
B.	2,000	
C.	250	
		£24,250[5]

(2) In Company C there are insufficient profits to cover the final Preference Dividend, so that in the meantime the balance forward must be regarded as belonging to outside shareholders (i.e. the preference shareholders of C). Actually at the end of 1951 the Holding Company has a two-thirds interest in the £200 balance of C, but it loses this interest in 1952 in favour of the preference shareholders. Whether the full outstanding dividend should be provided for in the accounts of C, resulting in a debit balance on its Profit and Loss Account, is a moot point.

(3) Associated Company—see below.

Associated Company. Although the term is often employed to indicate a subsidiary, it is more commonly meant to indicate—

(1) A company associated with another through mutual shareholdings insufficient to make either a holding company or a subsidiary.

(2) A company which has close trade associations with another.

(3) A company in which another company has a substantial holding of shares without constituting legal control.

(4) A company which is controlled by substantially the same individuals controlling another, e.g. A and B are the sole shareholders in both C, Ltd., and D, Ltd. These companies are associated companies.

PUBLISHED CONSOLIDATED ACCOUNTS

In examination work there will be no time usually to rewrite the consolidated accounts which have been prepared in draft form in one of the ways outlined in this chapter; in practice, of course, this will be done and from the fair copy the accounts will be prepared for publication. It will be remembered that the latter must comply in most respects with the requirements of the Companies Act, 1948, as if they were the accounts of an actual company. Subject to these detailed requirements which were given early in this chapter and in the previous chapter, the outline of the published accounts given below may be of assistance to the reader.

OUTLINE CONSOLIDATED BALANCE SHEET
AS AT

	£		£
Authorized Share Capital of H		Fixed Assets	
		Goodwill	
Issued Share Capital of H		Investments:	
Share Premium Account of H		(1) Trade	
Capital Reserves } *less*		(2) Quoted	
Reserves and Undistributed Profits } M.I.		(3) Unquoted	
		(4) Subsidiaries not consolidated	
TOTAL INTEREST OF SHAREHOLDERS OF H		Loans to Employees for Purchase of Shares	
Long-term Liabilities (detailed), e.g. Debentures, etc.		Current Assets (detailed)	
Provisions		Preliminary, etc., Expenses not yet written off	
Current Liabilities (detailed), including Bank Overdrafts[1] and Loans, and Proposed Dividends			
Minority Interest			
£		£	

[1] These should NOT normally be set off against Bank balances appearing under Current Assets.

Consolidated Profit and Loss Account for the (Period) ended ....

Dr.	£	*Cr.*	£
To Provisions for—		By Trading Profits, *less* Losses . .	
(1) Depreciation and Diminution in Value of Fixed Assets .		„ Dividends and Interest from—	
(2) Taxation (detailed where practicable)		Trade and Other Investments (detailed)	
(3) Other amounts . . .		Subsidiaries not consolidated .	
„ Debenture, etc., Interest . .		„ Sundry Income (detailed) . .	
„ Auditors' Remuneration (*vide* C.A., 1948, para. 13, Pt. I, 8th Sch.) .		„ Provisions re-credited . . .	
„ Net Profit c/d			
	£		£
To Appropriations to Reserve . .		By Balance from previous period . .	
„ Proportion of Profits applicable to Minority Shareholders . . .		„ Net Profit b/d	
„ Dividends paid and proposed by H .		„ Provisions no longer required (where inclusion in the upper section of the account might distort the net profit of the period)	
„ Balance carried forward (per Balance Sheet)—			
Profit of H			
Proportion of Profits of Subsidiaries applicable to H . . .			
	£		£

The following additional points should be noted—

(1) Whenever on consolidation a difficulty is encountered in the treatment of an item, it should be remembered that the primary object is to show a true and fair view of the state of affairs of the Group from the viewpoint of the members of the Parent Company.

(2) Although the Act requires the consolidated accounts to show the contents of the individual companies' accounts, the Directors are authorized to make such adjustments as they consider necessary. Thus, a pre-acquisition revenue reserve of a subsidiary becomes, and should be shown as, a capital reserve or as a deduction from Goodwill.

(3) As mentioned on page 1061 adjustments may be required for assets or liabilities the book values of which differ considerably from their portion of the purchase price. When such adjustments are not made in the books of the subsidiary, it may be necessary on consolidation, in the case of fixed assets, to make a provision for depreciation different from that made in the subsidiary's accounts. It will facilitate matters if the books of the subsidiary are adjusted to correspond with the depreciation charge in the consolidated accounts.

(4) Apart from the adjustments mentioned in (3), fixed assets are usually consolidated at cost to the various subsidiary companies, less aggregate depreciation since date of acquisition by each of those companies. Some accountants, however, prefer to take the net book amount valuation (i.e. cost less depreciation) at the date of acquisition, plus subsequent additions at cost, less accumulated depreciation since acquisition.

(5) When any change is made by a subsidiary in its reserves (e.g. by capitalization in bonus shares) this can have no effect on the consolidated assets and liabilities, but is merely a matter for adjustment in the group reserves.

Where, as is permitted by Section 151 (3) of the Companies Act, 1948, the group accounts are incorporated in the holding company's own Balance Sheet and Profit and Loss Account, the latter account will be similar to that already outlined in the previous chapter except that (1) each item will be subdivided into (*a*) Holding Company and (*b*) Subsidiaries, the total being extended into a final column; (2) the balance of the account will be split between (*a*) minority shareholders of subsidiaries, (*b*) Holding Company's profit, and (*c*) Holding Company's proportion of subsidiaries' profits, as in the consolidated account shown above.

In all cases, except for the first accounts laid before the company after the coming into force of the Companies Act, 1948, the corresponding figures for the previous year's accounts (including Balance Sheet) must be shown against each item.

For the auditors' report on group accounts, see the Ninth Schedule, Paragraph 4, reproduced on page 1047.

General Illustration. The following balances were taken from the books of H Ltd. and A Ltd. on 31st December, 1953—

	H, Ltd.	*A, Ltd.*
Debits:	£	£
Goodwill (cost)	8,000	5,000
Freehold Land and Buildings (cost)	25,000	—
Leasehold Land and Buildings (cost)	—	7,500
Plant and Machinery (cost)	40,000	5,000
Furniture and Fixtures (written down value at 31st December, 1947)	6,000	2,000
Furniture, etc. (additions 1948 to 1953 at cost)	3,000	500
Leasehold Amortization Fund Policies	—	3,800
Investments (cost):		
12,500 Ordinary Shares in A, Ltd.	30,000	—
1,500 Preference Shares in A, Ltd.	1,500	—
£20,000 Mortgage Debenture Stock of H, Ltd.	—	18,500
Sundry (quoted—market value £10,000)	15,000	—
Stocks (at or under cost)	7,250	13,000
Debtors:		
A, Ltd., Current Account	5,550	—
Sundry	10,000	18,000
Bills Receivable	4,000	—
Cash at Bank and in hand	10,000	100
Tax Reserve Certificates	2,500	—
	£167,800	£73,400
Credits:		
Share Capital (Authorized and Issued):	£	£
Ordinary Shares of £1 each	50,000	15,000
5% Cumulative Preference Shares of £1 each	—	2,000
4% Mortgage Debenture Stock	45,000	5,000
Share Premium Account	2,000	—
Carried forward:	£97,000	£22,000

	H, Ltd.	A, Ltd.
	£	£
Brought forward:	97,000	22,000
Creditors:		
H, Ltd.		5,550
Sundry	10,000	3,200
Bills Payable		3,000
Bank Overdraft		16,440
Depreciation:		
Plant and Machinery	13,000	1,000
Furniture and Fixtures	2,000	1,000
Provision for Doubtful Debts	500	
Sundry Provisions	10,000	
Leasehold Amortization Fund	—	3,800
Income Tax, 1953–54	2,000	500
General Revenue Reserve	5,000	2,000
Profit and Loss Account (Balance at 1st January, 1953)	5,000	1,600
Profit and Loss Account (Profit for the year)	23,300	13,310
	£167,800	£73,400

You obtain the following information:

(1) The Profit for the year has been arrived at after charging the following:

	£	£
Depreciation:		
Plant and Machinery	3 000	500
Furniture and Fixtures	500	200
Leasehold Amortization Fund	—	200
Managing Director's Salary	2,000	—
Debenture Interest paid to 30th June, 1953	495	55

(2) Provision is to be made for the following:

Income Tax, 1954–55	8,000	4,000
Profits Tax, 1953	1,500	1,000
Auditors' Remuneration (not yet fixed)	1,000	500
Proposed dividends, *less* tax (none having been paid during the year):		
Ordinary	20%	40%
Preference	—	5%

(3) Directors' Fees are to be provided of £1,200, of which £200 is payable by A, Ltd.

(4) The Profit for the year of H, Ltd., includes:

(*a*) £110 net interest received on sundry investments.

(*b*) £500 profit on sale of plant to A, Ltd., for £1,000.

(5) The Directors of H, Ltd., decide to regard the dividend receivable from A, Ltd., as being paid out of current profits.

(6) In the books of H, Ltd., £5,000 is to be provided against depreciation of investments, and the Directors decide that £6,000 sundry provisions are no longer required.

(7) Stocks of H, Ltd., include (at cost) £2,500 purchased from A, Ltd , at a profit to the latter of £1,000.

(8) During the latter part of the year, H, Ltd., drew Bills for £3,000, which were accepted by A, Ltd. H, Ltd., discounted £1,000 of them.

(9) H, Ltd., purchased its holding in A, Ltd., in the open market on 1st January, 1953. A, Ltd., purchased its H, Ltd. Debenture Stock in the open market prior to 1953.

The Directors decide to submit to the members of H, Ltd. a Balance Sheet of that company together with a Consolidated Balance Sheet and Profit and Loss Account, and you are asked to draft them. Show also Profit and Loss Account of H, Ltd., although this is not required for submission to the members.

H, LIMITED

Balance Sheet at 31st December, 1953

	£	£
Capital and Surplus—		
Share Capital—Authorized, Issued and fully paid:		
50,000 Ordinary Shares of £1 each		50,000
Capital Reserves:		
Share Premium Account	2,000	
Profit on Sale of Plant to Subsidiary Company	417[1]	
		2,417
Revenue Reserves:		
General	5,000	
Profit and Loss Account	14,179	
		19,179
		71,596
Amount set aside for Income Tax, 1954–55[2]		8,000
		79,596
4% Mortgage Debenture Stock		45,000
Provisions—		
Depreciation of Investments	5,000	
Sundry	4,000	
		9,000
Current Liabilities—		
Creditors (including £275 secured)	12,275[3]	
Taxation	3,500	
Proposed Dividend (net)	5,500	
		21,275
Note (1) There is a contingent liability in respect of Bills discounted, £1,000.		
(2) £20,000 of the Debenture Stock is held by the Company's subsidiary.		
		£154,871

	Cost, etc.	Accumulated Depreciation	
	£	£	£
Fixed Assets at cost, except where otherwise stated—			
Freehold Land and Buildings	25,000	—	25,000
Plant and Machinery	40,000	13,000	27,000
Furniture and Fixtures at net book value at 31st December, 1947, plus cost of subsequent additions	9,000	2,000	7,000
	£74,000	£15,000	59,000
Goodwill			8,000
			67,000
Investment in and Amounts owing by Subsidiary Company—			
Shares at cost		31,500	
Current Account, including Bills and Dividends receivable		10,121[4]	
			41,621
Current Assets—			
Stocks at or under cost		7,250	
Debtors, *less* provision for doubtful debts, and Bills Receivable		11,500[5]	
Investments (quoted) (Market value £10,000) at cost		15,000	
Tax Reserve Certificates		2,500	
Cash at Bank and in hand		10,000	
			46,250
Directors.			
			£154,871

[1] See footnote[4] to H, Ltd., Profit and Loss Account on page 1113.

[2] This may be included in Revenue Reserves above.

[3] Per question £10,000 plus Directors £1,000 plus Auditors £1,000 plus half year's Debenture Interest *less* tax on £45,000 (£275). The net debenture interest is £495, but £220 due to A, Ltd., is set off. If the latter amount was material, it would have to be shown as a secured liability.

[4] Per question £5,550 plus Bills £2,000 plus Dividends receivable £2,791 (5% on £1,500 and 40% on £12,500 *less* tax) *less* Debenture Interest £220 (4% on £20,000 for half-year, *less* tax).

[5] Per question £10,000 plus Bills £2,000 *less* Provision £500.

Last year's corresponding figures are required.

	£	£
Capital and Surplus—		
Share Capital of H Ltd —Authorized, Issued and fully paid		
50,000 Ordinary Shares of £1 each		50 000
Share Premium Account		2 000
Revenue Reserves		
H, Ltd		
General Reserve	5,000	
Profit and Loss Account	14 179	
	19,179	
A, Ltd		
Undistributed Profits attributable to the shareholding of H, Ltd	3,308	
		22 487
		74 487
Amount set aside for Income Tax, 1954–55		12 000
Outside Shareholders' Interest in A, Ltd —		
Share Capital, together with dividends and proportion of reserves and undistributed profits applicable thereto		5,151[1]
4% Mortgage Debenture Stock		30 000[2]
Provisions—		
Depreciation of Investments	5 000	
Sundry	4,000	
Against Inter company Profits on unsold stock	417[3]	
Leasehold Amortization Fund	3,800	
		13,217
Current Liabilities—		
Creditors (including £330 secured) and Bills Payable	17,230	
Bank Overdraft	16 440	
Taxation	5,000	
Proposed Dividend of H, Ltd (net)	5,500	
		44,170
		£179 025

	Cost, etc	Accumulated Depreciation	
Fixed Assets at cost except where otherwise stated—	£	£	£
Freehold Land and Buildings	25,000	—	25,000
Leasehold Land and Buildings	7,500	—	7,500
Plant and Machinery	44,583[4]	13,958	30,625
Furniture and Fixtures at net book value at 31st December, 1947, plus cost of subsequent additions	11,500	3,000	8,500
	£88,583	£16,958	71,625
Goodwill, including excess of cost of Shares in A, Ltd , over the net assets attributable thereto at date of acquisition			26,250[5]
			97,875
Leasehold Amortization Fund Policies			3,800
Current Assets—			
Stocks at or under cost		20,250	
Debtors, *less* provision for doubtful debts, and Bills Receivable		29,500	
Investments (quoted) (Market value £10,000)		15,000	
Tax Reserve Certificates		2 500	
Cash at Bank and in hand		10,100	
			77,350
			£179,025

The figures are obtained by simple addition, with the exception of the following—

[1] Preference Capital £500 + Ordinary Capital £2 500, plus ⅙ of General Reserve (£2 000) and Profit and Loss Account Balance (£1,600) = £600, plus ⅙ of Debenture Reserve (£20,000 − £18,500) = £250, plus per Profit and Loss Account £1,301

[2] H, Ltd , £45,000 *less* held by A, Ltd , £20,000, plus A, Ltd , £5 000

[3] See note[3] to Consolidated Profit and Loss Account on page 1113 The provision could be deducted from the aggregate stock figure. In practice, an overall round sum provision is often carried in the books against such unrealized profit

[4] H, Ltd , £40,000 plus A, Ltd , £5,000 *less* H, Ltd , Capital Reserve £417 (i e eliminating all profit on inter-company sale except for one-sixth minority interest). See also note[3] to Consolidated Profit and Loss Account on page 1113 and note[4] to H, Ltd. Profit and Loss Account on page 1113. Accumulated depreciation follows the same principle and is explained in note[3] and note[4] referred to above

[5] H, Ltd , £8,000 plus A, Ltd , £5,000 = £13,000, plus excess of cost of shares (£31,500) over nominal value (£14,000) and reserves and undistributed profits attributable thereto at date of acquisition [⅚ × (General Reserve £2,000 plus Profit and Loss Account £1,600 plus Debenture "Reserve" £1,500 (£20,000 − £18,500)) = £4,250]

CONSOLIDATED PROFIT AND LOSS ACCOUNT OF H, LTD., AND ITS SUBSIDIARY COMPANY A, LTD.,
FOR THE YEAR ENDED 31ST DECEMBER, 1953

		£	£
Aggregate Profit on Trading, subject to the following items.			42,730
Interest on Investments			200
Profit on Sale of Plant			83
			43,013
Deduct:			
Debenture Interest		1,200[1]	
Depreciation of Fixed Assets (no provision has been made in respect of Freehold Land and Buildings) . .		4,158[2]	
Leasehold Amortization Fund		200	
Auditors' Remuneration		1,500	
Remuneration of Directors of H, Ltd.:			
Fees	£1,200		
Executive Salary	2,000		
		3,200	
Taxation on Current Profits:			
Income Tax	£11,550[3]		
Profits Tax	2,500		
		14,050	
			24,308
			18,705
Less: Proportion attributable to outside Shareholders of A, Ltd.			1,301[4]
			17,404
Less: Provision against Inter-company Profits on unsold Stock			417[5]
Net Profits of the Group attributable to the members of H, Ltd.			16,987
Deduct: Profit retained in the books of A, Ltd. . .			3,308[6]
Net Profit of H, Ltd.			13,679
Add: Provisions no longer required			6,000
			19,679
Deduct: Provision for Depreciation of Investments .		5,000	
Proposed Dividend (net)		5,500	
			10,500
			9,179
Balance brought forward from previous year . . .			5,000
Balance carried to Balance Sheet			£14,179

In all cases the above figures are obtained by simple addition of the amounts shown in the Profit and Loss Accounts of H, Ltd. and A, Ltd., on pages 1113 and 1114, except for the items explained in footnotes 1 to 6, which appear at the foot of page 1113.

H, LIMITED

Profit and Loss Account
for the Year ended 31st December, 1953

	£	£		£	£
To Debenture Stock Interest		1,800	By Trading Profit		28,685[2]
,, Depreciation (no provision has been made in respect of Freehold Property)		3,500	,, Dividends and Interest receivable:		
,, Auditors' Remuneration		1,000	Sundry Investments	200	
,, Directors' Emoluments:			Subsidiary Company	5,075[3]	
Fees	1,200				5,275
Executive Salary	2,000		,, Profit on Sale of Plant to Subsidiary Company (*less* amount transferred to Capital Reserve)		83[4]
	3,200				
Less payable by Subsidiary Company	200				
		3,000			
,, Taxation on Current Profits:					
Income Tax	9,564[1]				
Profits Tax	1,500				
		11,064			
,, Net Profit for the year carried down		13,679			
		£34,043			£34,043
To Provision for Depreciation of Investments		5,000	By Balance brought forward		5,000
,, Proposed Dividend (net)		5,500	,, Net Profit brought down		13,679
,, Balance carried to Balance Sheet		14,179	,, Provisions no longer required		6,000
		£24,679			£24,679

[1] Income Tax 1954-55 per question, £8,000 plus tax deducted from dividends, etc., receivable £2,374, less tax recouped on debenture interest £810.

[2] Per question £23,300, plus debenture interest to 30th June apparently debited net £495, plus Depreciation £3,500 and Managing Director's salary £2,000, less interest received net £110 and profit on sale of plant £500.

[3] Preference (gross) £75 plus Ordinary (gross) £5,000.

[4] The profit may be regarded as realized to the extent of the minority interest in A, Ltd., i.e. one-sixth: $\frac{1}{6}$ of £500 is therefore credited here and the balance £417 has been transferred to Capital Reserve. Alternatively, the whole £500 might have been put to Reserve, no profit being taken on the transaction.

Last year's corresponding figures would be required.

Footnotes from page 1112.

[1] H, Ltd., £1,800 less received by A, Ltd., £800, plus payable by A. Ltd., £200.

[2] H, Ltd., £3,500 plus A, Ltd., £700 = £4,200 less £42 = £4,158. It is assumed that A, Ltd.'s rate of depreciation is 10% of cost. In the Consolidated Balance Sheet, A, Ltd.'s plant has been reduced by H, Ltd.'s unrealized profit on sale ($\frac{5}{6}$ × £500); depreciation is therefore reduced by $\frac{5}{6}$ of 10% of £500 = £42.

[3] H, Ltd., £9,564 less tax on gross dividends from A, Ltd., £2,284 = £7,280 plus A, Ltd., £4,270; tax on inter-company debenture interest automatically cancels out.

[4] $\frac{1}{6}$ of A, Ltd., undistributed profit (£4,420) = £737 plus share of dividends £564 (Preference, $\frac{1}{4}$ of £55 = £14; Ordinary, $\frac{1}{6}$ of £3,300 = £550).

[5] Unrealized profit £1,000, of which $\frac{5}{6}$ attributable to H, Ltd. = £833, less income tax and profits tax, say, 50%, £416 = £417.

[6] $\frac{5}{6}$ × £4,420 = £3,683 plus £42 (note[2]) less £417 (note[5]).

To assist in following the Consolidated Profit and Loss Account, A, Ltd. Profit and Loss Account is given below in summary form—

	£	£
Trading Profit £[13,310 + 55 + 700 + 200 — 220]		14,045
Debenture Interest from H, Ltd. (gross) [2 × £(220 + 180)]		800
		14,845
Debenture Interest payable (gross) [2 × £(55 + 45)]	200	
Depreciation and Leasehold Amortization Fund	900	
Directors' Fees	200	
Auditors' Remuneration	500	
Income Tax £[4,000 + 360 — 90]	4,270	
Profits Tax	1,000	
		7,070
		7,775
Preference Dividend (net)	55	
Ordinary Dividend (net)	3,300	
		3,355
		£4,420

The following matters should be noted—

(1) The method of presentation of accounts chosen by the Directors is one of those permitted by the Companies Act, 1948 (Section 149 (5)), i.e. without showing a separate Profit and Loss Account of H, Ltd. It should, however, be remembered that in this method the Account is the Profit and Loss Account of H, Ltd. *framed as a consolidated account* and not a consolidated account pure and simple. Paragraph 19 of the 8th Schedule, which permits details of directors' emoluments, etc., to be omitted from the consolidated accounts, does not therefore apply; furthermore, the account must show how much of the consolidated profit is dealt with in the accounts of H, Ltd.

(2) The primary object of group accounts is to show the state of affairs and earnings of the group from the point of view of the members of the holding company; there is thus no point, in normal circumstances, in attempting to provide information to outside shareholders, etc., and the aggregate amount of their interest is all that is usually required. Furthermore, the Directors are empowered under the Companies Act, 1948, to make such adjustments as they consider necessary to attain the primary object.

(3) Bank overdrafts should *not* normally be set off against credit balances on consolidation, but should be shown separately.

(4) The question does not indicate whether, in arriving at the purchase price for the shares in A, Ltd., the net assets were taken into account at their book value or at a higher (or lower) market value. If such was the case, an adjustment would be desirable, decreasing (or increasing) the amount now shown for goodwill, etc.

(5) Some accountants prefer to aggregate fixed assets of subsidiaries at net book value at date of acquisition of shares by the holding company with accumulated depreciation since that date, instead of the method adopted in the illustration.

CHAPTER XXV

DOUBLE ACCOUNT SYSTEM

THIS is the name given to the method of presenting the published accounts of certain companies, usually of the public utilities type. It is not meant to indicate a special system of book-keeping, and all companies adopting this system of presenting their accounts keep their books on the ordinary double-entry principles.

The system, being applied chiefly to Railways, Gas and Electric Lighting companies, all of which are now State owned, is not in every day use, except that many Water Companies still draw up their published accounts thereunder.

This chapter, therefore, will be confined to general principles only.

The General Principles. Under the double account system, the Balance Sheet is in two parts, viz.—

(1) The Receipts and Expenditure on Capital Account.

(2) The General Balance Sheet.

The first part, that is, the Receipts and Expenditure on Capital Account, deals with the funds raised and fixed assets acquired. On the credit side appears the cash received from the issue of stock, shares, debentures, and *loans*, together with any premiums thereon. Discounts on these items, if any, are usually deducted from the premiums, and the net figure carried out. On the debit side are shown the various fixed assets purchased out of the capital moneys, including loans raised.

Although (except for the provision of Sect. 57 of the Companies Act, 1948) limited companies may not issue shares at a discount, the special Acts under which "Double Account" companies are incorporated usually permit the issue of stock and shares at a discount, under certain conditions, even though such issue may be an original issue of the stock or shares in question.

The balance of the Capital Account (or, in the case of electrical undertakings, the totals of the respective sides) is carried down and shown as a separate item in the General Balance Sheet. As the items in the Receipts and Expenditure on Capital Account are shown on the same sides as they actually appear in the books, the *balancing* item in the Capital Account appears on the SAME side in the General Balance Sheet, as will the totals if carried down, because the items in the General Balance Sheet are on the same sides as are adopted by other companies; e.g. if the capital moneys received amount to £1,000 and expenditure thereout is £750, there is a credit balance of £250 which will appear upon the liabilities side of the General Balance Sheet, i.e. the "debit side," the balancing figure being on that side of the Receipts and Expenditure on Capital Account. The Receipts and Expenditure on Capital Account is

generally shown in columnar form, there being three columns on each side, the first presenting the totals up to the time of the commencement of the accounting period, the second the amount spent or raised during the accounting period, and the third the total of the first two columns.

The General Balance Sheet deals with the remaining assets and liabilities which may be considered as floating capital. It will usually be found to contain reserves and depreciation funds (if any) which have been built up out of profits.

The difference between the presentation of the accounts of companies operating under the double account system and those drawn up in the usual way (designated by way of contrast as the single account system) is shown clearly in the following illustration.

Illustration. (1) Double Account system—

Dr. CAPITAL ACCOUNT *Cr.*

			£				£
	To Fixed Assets (detailed)		41,000		By Ordinary Stock		50,000
	„ Balance		9,000				
			£50,000				£50,000

GENERAL BALANCE SHEET

	£		£
Balance of Capital Account	9,000	Stocks and Stores . .	8,500
Revenue Account . .	3,000	Cash at Bank . . .	5,500
Depreciation Fund . .	2,000		
	£14,000		£14,000

(2) Single Account system—

BALANCE SHEET

	£			£
Ordinary Stock . . .	50,000	Fixed Assets (detailed) .	£41,000	
Profit and Loss Account .	3,000	*Less* Depreciation .	2,000	
				39,000
		Stocks and Stores . . .		8,500
		Cash at Bank . . .		5,500
	£53,000			£53,000

The characteristic features of the system are—

(1) The assets purchased remain in the books at the cost price and are not written down, so that—

(2) Depreciation is provided for by the creation of reserves and other funds, which appear on the liabilities side of the General Balance Sheet.

(3) Loans and debentures are considered as "capital," and consistent with this procedure, loan and debenture interest are debited to Revenue *Appropriation* Account, like dividends.

(4) Discounts and Premiums on Capita Stock and Debentures are permanently retained as Capital items.

(5) Renewals are provided for out of current revenue.

(6) Accounts, particularly in the case of railways, are supported by voluminous statistical returns.

(7) The Balance Sheet is presented in two parts. *Capital* Receipts and Expenditure the balance of which is carried down into the Balance Sheet (*a*) if the Receipts exceed Expenditure to the left hand and (*b*) if Expenditure exceeds Receipts to the right hand.

The system comes in for criticism on the following grounds—

(1) That inasmuch as assets remain at cost in the Capital Account the Balance Sheet does not show the true position. Against this is to be stated that whilst the system permits the permanent inclusion of assets at cost, the practice is to build up depreciation and other funds to cover obsolescence, and wear and tear of the asset.

(2) That included in the Capital Account is expenditure on fictitious assets, e.g. expenditure in connection with the promotion of Parliamentary bills—even those in opposition to rival schemes—and preliminary expenses; but the same criticism is applicable under the Single Account System.

(3) That included in the capital are assets which have a very short life.

(4) That inasmuch as renewals are charged to revenue, involving, perhaps, little or no expenditure in some years and very heavy expenditure in others, each year's profits (or losses) are incorrectly stated. On the other hand, by proper provision by way of renewal funds a just proportion can be debited to revenue, so that revenue will be charged with an amount approximating to the depreciation incurred *during* the life of the asset. Particular attention will have to be paid to this question in the early years of a company, because actual renewals will be very small.

(5) That the precise determination of the amount properly chargeable to revenue in respect of renewals is difficult or impossible to calculate.

(6) Lack of understanding of the accounts by the general public.

Replacements. The treatment of replacements, especially where improvements are effected, often causes great perplexity in the mind of the student. The main point is that once an asset appears in the Receipts and Expenditure on Capital Account it is never shown at a less figure (e.g. in respect of sale or depreciation), although it may be increased.

CHAPTER XXVI

UNDERWRITERS' ACCOUNTS

THE business of an underwriter is that of guaranteeing to subscribe for an agreed number of shares (or amount of stock), usually being the difference between the shares (or stock) issued, and those taken up by the public. In consideration of this guarantee, the company making the issue agrees to pay a commission termed underwriting commission. As has been mentioned in Chapter XXIII, the amount and rate of such commission must be authorized in the Articles of Association, and the amount paid must be shown in the Balance Sheet of the company until written off.

In many cases, the underwriters themselves make sub-agreements with their business friends, who receive a share of the commission. In these circumstances a company will often pay a further commission called an "overriding" commission, which is a payment made to an underwriter for "placing" underwriting agreements with sub-underwriters.

The principles involved in ordinary commercial accounts are applicable (subject to appropriate modifications), i.e. the Underwriting Account is a Profit and Loss Account, to which expenses are debited and commission credited.

The most important point to which the student must give attention, is the position which arises when the underwriter has taken up shares or stock (i.e. where shares or stock have not been fully subscribed). In this case such shares or stock should be regarded as stock of goods acquired by a trader, so that when the underwriter is called upon to take up his quota, he will debit Underwriting Account with the amount paid for the shares or stock and credit cash. Shares or stock unsold at the date of drawing up the accounts will be credited to the Underwriting Account at cost or market value, whichever is the lower.

Illustration. X underwrites an issue of 100,000 shares of £1 each in consideration of a commission of 4 per cent payable in cash. The public having subscribed for 95,000 only, X under the terms of his contract subscribes for and is allotted the remaining 5,000. His expenses are £100. When he draws up his accounts no shares have been sold. The market value of the shares is 12s. each.

Show Underwriting Account.

Dr. UNDERWRITING ACCOUNT *re* . . . . *Cr.*

		£			£
To Expenses . . .		100	By Cash: Commission .		4,000
,, Cash payment for Shares		5,000	,, Shares: 5,000 at Cost .	c/d	1,100
		£5,100			£5,100
To Balance . . .	b/d	1,100			

It should be noted that in effect the underwriter has expended £1,100 and is the holder of shares worth (at their market value) £3,000. The commission is not taken, in this case, as a separate profit, but as a part of the whole underwriting transaction.

It is a matter of business prudence not to take the commission as a separate profit, as it is merely a part of the whole underwriting transaction. Assuming that all expenses were paid by cheque, and that none were outstanding, it is clear that the underwriter's Bank Account will be overdrawn to the extent of £1,100 in respect of this transaction, and this amount must, therefore, be the true cost.

The contrary view is frequently asserted, however, and if it is applied, the accounts would be shown as follows—

Dr. UNDERWRITING ACCOUNT *re* . . . . *Cr.*

		£			£
To Expenses . . .		100	By Shares 5,000 at 12s. each	c/d	3,000
,, Payment for Shares by Cheque . . .		5,000	,, Loss transferred to Commission Account .		2,100
		£5,100			£5,100
To Balance . . .	b/d	3,000			

Dr. COMMISSION *Cr.*

		£			£
To Loss transferred from Underwriting Account		2,100	By Commission . .		4,000
,, Profit		1,900			
		£4,000			£4,000

It is submitted that the first view is preferable, as in view of the risk there can be no question of true profit until £1,100 is recouped.

Illustration. The above-mentioned underwriter sold, a few days after he had closed his books for the year, 2,000 shares at 11s. 6d., the market value of the remaining shares at the close of the current period being 10s. Show Underwriting Account.

Method (1).

Dr. UNDERWRITING ACCOUNT *re* . . . . *Cr.*

		£			£
To Shares: 5,000 at Cost .	b/d	1,100	By Sale: 2,000 Shares at 11s. 6d. each . .		1,150
,, Profit		50	,, Shares: 3,000 at Cost .		—
		£1,150			£1,150

The remaining 3,000 shares must have cost nil as the total cost of £1,100 has already been recouped, leaving in addition a surplus of £50 profit. (The Bank Account will now show £50 in hand.)

Method (2).

Dr. UNDERWRITING ACCOUNT *re* . . . . *Cr.*

		£			£
To Balance: Shares, 3,000 at 12s. each . . .	b/d	3,000	By Sale: 2,000 Shares at 11s. 6d. each . .		1,150
			„ Shares: 3,000 Shares at 10s. each . . .	c/d	1,500
			„ Loss		350
		£3,000			£3,000
To Balance . . .	b/d	1,500			

Illustration. Assume that in the next period the underwriter sells all the remaining shares (3,000) at 15s. Show Underwriting Account.

Method (1).

Dr. UNDERWRITING ACCOUNT *re* . . . . *Cr.*

		£			£
To Balance: Shares, 3,000 at cost . . .		—	By Sale: 3,000 Shares at 15s. each		2,250
„ Profit		2,250			

Method (2).

Dr. UNDERWRITING ACCOUNT *re* . . . . *Cr.*

		£			£
To Balance: Shares, 3,000 at 10s. each . . .	b/d	1,500	By Sale: 3,000 Shares at 15s. each. . . .		2,250
„ Profit		750			
		£2,250			£2,250

The results are compared below—

1st Method		£	2nd Method		£
Year 1	Profit	—	Year 1	Profit	1,900
2	Profit	50	2	*Loss*	*350*
3	Profit	2,250	3	Profit	750
	Profit . .	£2,300		Profit . . .	£2,300

The eventual results must be the same in both methods, but it will be seen that whilst the first method practically always avoids subsequent losses, it tends to disclose a comparatively big profit long after the date of the original transaction.

It often happens that underwriters, for the purpose of their business, enter into syndicates, which are neither limited companies, nor partnerships, but merely combinations of entirely separate operators formed for convenience. In these cases each underwriter receives commission on the shares he underwrites personally and is only liable to take up his own proportion.

Illustration. A and B underwrite an issue of 10,000 shares, A agreeing to underwrite 6,000 and B 4,000. Their commission is to be at the rate of 5 per cent. The public subscribe for 4,000 only.

Show the number of shares each underwriter must subscribe for, and the manner in which the commission is split.

The number of shares not taken up by the public is 6,000.

	Shares	Commission
		£
Proportion for which A must subscribe is $\frac{6,000}{10,000}$ × 6,000 .	3,600	
Proportion of commission due to A $\frac{6,000}{10,000}$ × £500 . .		300
Proportion for which B must subscribe is $\frac{4,000}{10,000}$ × 6,000 .	2,400	
Proportion of commission due to B $\frac{4,000}{10,000}$ × £500 . .		200
	6,000	£500

The books of A and B are quite separate, and save for the fact that they have joined names to the above-mentioned underwriting contract there is no other connection between them.

It has been mentioned that it is usual for underwriters to obtain assistance from other persons in order to fulfil their contract, just as a contractor "lets out" a portion of his contract to sub-contractors. It is important to bear in mind in these cases, however, that no privity of contract exists between the sub-underwriter and the company.

Illustration. X agrees to underwrite 10,000 shares of £1 each in W, Ltd., in consideration of a commission of 5 per cent. X makes an agreement with Y for the latter to sub-underwrite 1,500 of the shares mentioned at a commission of 3 per cent. Assume that the public subscribes for 4,000 shares (at par). Subsequently the shares taken up by X are sold at 19s., and those taken up by Y at 20s. 3d. Expenses were £100 paid by X. Ignore brokerage. Show Underwriting Account in X's books.

Dr. UNDERWRITING ACCOUNT *re* W, LTD. *Cr.*

	£		£
To Expenses	100	By Cash: Commission .	500
,, Cash: Shares taken up .	6,000	,, Shares taken up by Y, $\frac{15}{100}$ × 6,000 . .	900
,, Cash: 3% Commission to Y[1] . . .	45	,, Cash: Sale of 5,100 Shares at 19s. each .	4,845
,, Profit	100		
	£6,245		£6,245

The sale by Y does not concern X, the profit of the latter being made up as follows—

	£	£
Commission, *less* Expenses	400	
Less Commission to Y	45	
		355
Less Shares taken up at Cost . . .	5,100	
Less Proceeds of Sale . . .	4,845	
		255
Total Profit [as above]		£100

[1] 3% on 1,500 shares of £1 each.

No account is taken of interest on capital employed.

Where shares are given in part satisfaction of the commission and shares are required to be taken up because of the failure of the public to subscribe fully to the issue, the Underwriting Account will include two distinct items for shares, i.e. those taken up and paid for, and those received by way of commission.

Illustration. A, Ltd., issues 10,000 preference shares of £1 each, and 100,000 ordinary shares of 1s. each to the public, and 400,000 ordinary shares of 1s. each to the vendor. X underwrites 50 per cent of the issue in consideration of commission at the rate of 5 per cent, 1 per cent of such commission to be allotted out of the vendor's 400,000 shares and the remainder to be paid in cash. The public subscribed for 60 per cent of each class. The underwriter took up his proportion, and sold the preference shares for 15s. and the ordinary shares for 1s. 3d. Later he sold the ordinary shares received as remuneration for 6s., all these transactions taking place within the same financial year as the underwriting. Expenses may be ignored. Show Underwriting Account.

The first point to observe is that X underwrites half only, and therefore his remuneration will be 5 per cent of £7,500, the latter figure being arrived at as follows—

$$\tfrac{1}{2} \times £10{,}000\ (£5{,}000) + \tfrac{1}{2} \times \frac{100{,}000}{20}\ (£2{,}500) = \underline{£7{,}500}$$

Secondly, he is liable to take up only half of the shortage, viz.—

	Cost £
Preference Shares: $\tfrac{1}{2} \times 40\% \times 10{,}000 = 2{,}000$ at £1 .	2,000
Ordinary Shares: $\tfrac{1}{2} \times 40\% \times 100{,}000 = 20{,}000$ at 1s. .	1,000

Thirdly, his commission of £375 is payable—

	£
$\tfrac{1}{5}$ in Ordinary Shares, i.e. 1,500 shares of 1s.	75
$\tfrac{4}{5}$ in Cash	300
	£375

Dr. UNDERWRITING ACCOUNT *re* A, LTD. *Cr.*

		£			£
To Cash—	1		By Commission—		
Preference Shares taken up . . .		2,000	Cash . . .	1	300
Ordinary Shares taken up . . .		1,000	Shares . . .		75
,, Ordinary Shares received as Commission .		75	,, Cash Sale—		
,, Profit		500	2,000 Preference Shares at 15s. each . .		1,500
			20,000 Ordinary Shares at 1s. 3d. each .		1,250
			1,500 Ordinary Shares at 6s. each . .		450
		£3,575			£3,575

[1] Bank in practice.

Many other alternatives exist (e.g. the shares taken up dealt with in a separate account), but whatever particular method of treatment is adopted, it is generally agreed that it is advisable to take no profit until a proportion of shares has been sold sufficient to cover the original cost. As previously indicated, the bank overdraft (if any) will normally indicate how much remains to be recouped before a profit can be truly considered to have been earned.

It will be observed that the second lot of ordinaries have been sold at an enhanced price—a fact which should put the student on his guard as regards the date of sale. The illustration specifically states that the sale took place in the same accounting period, but in the absence of such information, the student should make a note in his answer pointing out the possibility of the further sale having taken place in a subsequent period, hence calling for the Underwriting Accounts to be closed with the latter shares on hand at a valuation.

Illustration. X underwrote 100,000 shares of £1 each, in consideration of commission at the rate of 5 per cent, 4 per cent in cash and 1 per cent in shares. X had to take up 30,000 shares at par. At the date of the account, X still retained the shares, the market value being then 16s. each share. Expenses to be ignored. Show Underwriting Account.

Dr UNDERWRITING ACCOUNT *re* . . . . *Cr*

		£			£
To Cash Payment for Shares		30,000	By Commission—		
,, Shares . .		*1,000	Cash	£4,000	
			Shares	*1,000	5,000
			,, Shares—		
			31,000 at 16s each .		24,800
			,, Loss . . .		1,200
	£	31,000		£	31,000

It is clear that the total outlay to date is—

	£	£
Cash for shares taken up	30,000	
Less Cash Commission received . . .	4,000	
		26,000
Market value of 31,000 shares at 16s. each . .		24,800
Representing a loss to the Underwriter of . .		£1,200

Alternatively, the items marked (*) might be included at nil, but the resultant answer would be the same; or, again, separate Shares Accounts might be opened. If the shares had a market value of, say, 19s., the shares would be brought in at cost, i.e. £26,000. If X had sold, say, 10,000 of the shares at £2 12s., he would have exactly recouped his total outlay of £26,000, thus leaving the realization of the remaining 21,000 shares to be considered entirely as profit.

Relief of Liability. As an added inducement to the underwriters it is a common practice to insert in the contract a "relief" clause, providing that any subscriptions from the public bearing the stamp of the underwriter are taken into account in mitigation of liability should the issue not be fully subscribed. The problem is not one of pure accountancy at all, but merely one of arithmetic in order to ascertain what shares, if any, are to be subscribed for by an underwriter. Once the number is ascertained the entries are made along the lines indicated below.

Illustration. Underwriters agree to underwrite an issue of 10,000 shares; A assuming liability for 30 per cent, B for 10 per cent, C for 5 per cent, D for 40 per cent, and E for 15 per cent. Applications bearing the stamp of an underwriter are to be applied in relief of his liability. The following subscriptions are received—

Direct from public, 3,000 shares.

Forms bearing stamps of the underwriters—

	Shares
A	1,000
B	900
C	500
D	—
E	1,000
	3,400

Prepare statement of each underwriter's liability. (See next page.)

There still remain 3,600 shares to be taken up by the underwriters. The first step is to ascertain the "*shortage*" from the "*public*," IGNORING "marked" forms, i.e. 10,000 − 3,000 = 7,000 shares. Secondly, the liability is determined on the basis of the "gross" shortage from which are deducted the stamped forms of the underwriters. If as a result of such deductions there is an "excess," the latter is allocated in further relief of those underwriters whose liability has not been completely cancelled by the deduction of their own reliefs in respect of marked forms.

The marked applications are deducted from liabilities as shown on page 1125 (column 2).

Next the ultimate balance is ascertained. This is either (*a*) net liability (see column 3), or (*b*) the excess of shares in relief over liability. It will be seen that—

	Shares
"Gross" shortage	7,000
Less "Marked" Forms	3,400
"Net" Shortage	3,600

From columns 3 and 4 it is seen that, assumed the Shares are £1 issued at par, there is a liability of £3,950 for A, D, and E, and an excess of £350 for B and C. As the company requires no more than £3,600 from the underwriters, the above excess is allocated in

Statement of Underwriters' Liability

Underwriter	Original Proportions	"Gross" Liability	Relief for "Marked" Forms	Liability	Excess	First Division of Excess	Allocation of Excess	Liability after Allocation of 5	Excess after Allocation	Second Division of Excess	Allocation of Excess	Final Liability
		1	2	3	4		5	6	7			8
A	$\frac{30}{100} \times 7{,}000$	2,100	1,000	1,100		$\frac{3}{8\frac{1}{2}} \times 350$	123	977		$\frac{3}{7} \times 12$	5	972
B	$\frac{10}{100} \times 7{,}000$	700	900		200							
C	$\frac{5}{100} \times 7{,}000$	350	500		150							
D	$\frac{40}{100} \times 7{,}000$	2,800		2,800		$\frac{4}{8\frac{1}{2}} \times 350$	165	2,635		$\frac{4}{7} \times 12$	7	2,628
E	$\frac{15}{100} \times 7{,}000$	1,050	1,000	50		$\frac{1\frac{1}{2}}{8\frac{1}{2}} \times 350$	62		12			
		7,000	3,400	3,950	350		350	3,612	12		12	3,600
				$\underbrace{}_{3,600}$				$\underbrace{}_{3,600}$				

favour of A, D, and E in the proportion of their *original* liability, viz. 3 : 4 : 1½, as follows—

$$\begin{array}{llr} & & \text{Shares} \\ A & \dfrac{3}{8\frac{1}{2}} = \dfrac{6}{17} \times 350 = & 123 \\ D & \dfrac{4}{8\frac{1}{2}} = \dfrac{8}{17} \times 350 = & 165 \\ E & \dfrac{1\frac{1}{2}}{8\frac{1}{2}} = \dfrac{3}{17} \times 350 = & 62 \\ & & \overline{350} \end{array}$$

This is extended into column 5. As a result, E's liability is now eliminated, and finally there is disclosed an "excess" of 12 shares in his favour. These shares are now allocated in favour of A and D in their *original* proportions of 3 : 4, thus finally disposing of the liability of £3,600.

"Firm Underwriting." Where an underwriter wishes to subscribe for shares irrespective of his potential liability under the underwriting contract, that is, he stipulates that he be allotted a given number of shares, whether the issue is over-subscribed or not, he is said to underwrite "firm." If, for example, underwriters underwrite 20,000 Shares "firm" in respect of an issue of 200,000 Shares and the public apply for 540,000 Shares there will be only 180,000 Shares available for them (one share allotted for every three applied for in the aggregate, although the allotments made may be in different ratios according to the amounts applied for.)

The Shares underwritten "firm" or otherwise must be disclosed in the prospectus of a public company.

The special nature of the "firm" application must be ignored for the purpose of ascertaining liability under the underwriting, and therefore in computing the "gross" liability the "firm" application will be included in the public applications.

Illustration. The following underwriting of shares takes place: A, 6,000; B, 2,500; and C, 1,500. In addition there is "firm" underwriting: A, 800; B, 300; and C, 1,000. The share issue is 10,000.

The total subscriptions *including* "firm" underwriting were for 7,100 shares, including the following "marked" forms: A, 1,000; B, 2,000; and C, 500. Show the allocation of liability of the underwriters.

The procedure is as follows—

(1)

	"Open" underwriting.	"Firm" underwriting.
	Shares	Shares
A	6,000	800
B	2,500	300
C	1,500	1,000
	10,000	2,100

(2) Shares applied for by public—

	Shares
(a) Outsiders	5,000
(b) "Firm" Underwriting . .	2,100
	7,100

(3) Shares to be taken up under underwriting contract—

	Shares
Shares Underwritten . . .	10,000
Less Shares applied for by public as shown in (2) . . .	7,100
"Net" Shortage . . .	2,900

(4) The "firm" underwriting being considered as part of, and included in public subscriptions may be ignored from consideration in determining the appropriate division of the "net" shortage amongst the underwriters, viz., the number of shares the company requires to complete the issue of 10,000 shares.

(5) The public subscriptions include, however, 3,500 shares bearing "marked" forms which are to be allocated in mitigation of each underwriter's "gross" liability. These shares must be eliminated from the public subscriptions in order to compute the "gross" liability, thus—

		Shares
Shares issued		10,000
Less Public Subscriptions . .	7,100	
Less Subscriptions bearing "marked" forms . . .	3,500	
		3,600
"Gross" liability . .		6,400

This is the basis of the primary liability of the underwriters, from which will be deducted the "marked" applications for 3,500 shares, leaving the 2,900 shares to be subscribed by the underwriters, thus—

STATEMENT OF UNDERWRITERS' LIABILITY

Under-writers	Original Proportion of Liability	Gross Liability	Relief for "Marked" Forms	Liability	Excess	Division of Excess	Allocation of Excess	Final Liability
A	60% × 6,400	3,840	1,000	2,840		$\frac{60}{75}$ × 400	320	2,520
B	25% × 6,400	1,600	2,000		400			
C	15% × 6,400	960	500	460		$\frac{15}{75}$ × 400	80	380
		6,400	3,500	3,300	400		400	2,900
				2,900				

The underwriters will therefore take up shares as follows—

	"Open" Underwriting	"Firm" Underwriting	Total
A .	2,520	800	3,320
B .	Nil	300	300
C .	380	1,000	1,380
	2,900	2,100	5,000

The company will therefore allot shares as follows—

		Shares
(1) Underwriters under Contract . .		2,900
(2) Underwriters for "Firm" Underwriting (i.e. as ordinary applicants) .		2,100
(3) Outsiders [as per question] . .	7,100	
Less "Firm" applications in (2) .	2,100	
		5,000
Total		10,000

If the liability is to be taken into account *after* bringing into account marked forms, it will be—

A. 60% × 2,900 . . .	1,740
B. 25% × 2,900 . . .	725
C. 15% × 2,900 . . .	435
	2,900

Marine Underwriting. The accounts of underwriters of marine risks call for no particular comment except that the excess of income over expenditure is usually carried forward for a period of years (usually three), at the end of which the final balance is considered as profit or loss.

Illustration. The following balances at 31st December, 1952, are in the books of M. A. Reane, an underwriter at Lloyd's—

			1950	1951	1952
			£	£	£
Premiums, less Returns and Reinsurance . . .		1st year	2,500	2,305	2,400
		2nd "	300	450	
		3rd "	40		
Salvages		1st "	80	40	30
		2nd "	50	30	
		3rd "	10		
Taxed Income during year		1950	20		
		1951	40	25	
		1952	45	30	20
Claims		1st year	500	600	650
		2nd "	700	800	
		3rd "	250		
Expenses and Commissions			450	560	200
Re-insurance to close 1950			270		
Other Balances—	£				
Investments at Cost	3,675				
Debtors, *less* Creditors	600				
Creditors, less Debtors	450				
Cash at Bank	420				
Capital Account, 1st January, 1952 . . .	870				

Prepare Underwriting Accounts to 31st December, 1952, and Balance Sheet on that date. There are no drawings.

(For guidance to the reader the credit balances are printed in *italics*.)

UNDERWRITING ACCOUNT
YEAR 1950

Dr.

	£	£	£
To Claims, 1950	500		
Less Salvages	80		
		420	
" Claims, 1951	700		
Less Salvages	50		
		650	
" Claims, 1952	250		
Less Salvages	10		
		240	
			1,310
" Re-insurance of remaining Claims			270
			1,580
" Expenses and Commissions			450
" Balance: Net Profit to Balance Sheet			915
			£2,945

Cr.

	£	£
By Premiums (*less* Returns and Re-insurances)—		
1950	2,500	
1951	300	
1952	40	
		2,840
" Taxed Income (net)—		
1950	20	
1951	40	
1952	45	
		105
		£2,945

UNDERWRITING ACCOUNT
YEAR 1951

Dr.

	£	£	£
To Claims, 1951	600		
Less Salvages	40		
		560	
" Claims, 1952	800		
Less Salvages	30		
		770	
			1,330
" Expenses and Commissions			560
			1,890
" Balance, subject to future Claims			920
			£2,810

Cr.

	£	£
By Premiums (*less* Returns and Re-insurances)—		
1951	2,305	
1952	450	
		2,755
" Taxed Income (net)—		
1951	25	
1952	30	
		55
		£2,810

UNDERWRITING ACCOUNT
YEAR 1952

Dr.

	£	£
To Claims, 1952	650	
Less Salvages	30	
		620
" Expenses and Commissions		260
" Balance, subject to future Claims		1,540
		£2,420

Cr.

	£	£
By Premiums (*less* Returns and Re-insurances), 1952		2,400
" Taxed Income (net), 1952		20
		£2,420

BALANCE SHEET, 31ST DECEMBER, 1952

	£	£		£
Creditors (*less* Debtors) .		450	Investments at cost . .	3,675
Capital Account—			Debtors (*less* Creditors) .	600
Balance, 1.1.52 .	870		Bank	420
Underwriting Account, 1950: Net Profit .	915			
		1,785		
Balance forward—				
1951 . . .	920			
1952 . . .	1,540			
		2,460		
		£4,695		£4,695

Notes on Working. A quick rough Trial Balance can be prepared in a few minutes, thus—

	Dr. £	Cr. £
1950 column	2,170	3,085
1951 column	1,960	2,880
1952 column	910	2,450
Other Balances	4,695	1,320
	£9,735	£9,735

The Underwriting Account, which is a form of Profit and Loss Account, is treated on the usual lines, Premiums, etc., being the gains and Claims (against which are set off Salvages) the losses; but each year is kept "open" for three years, as a considerable length of time elapses before all the claims are finally disposed of. In the illustration the 1950 account is still in being (against which claims, though probably small, may yet come in), but in this instance the underwriter has re-insured against such loss, so that the balance of that year may be now considered as final profit; but 1951 and 1952 are still "open" in the sense that, as further claims are likely, the balances are in the nature of a "Fund" or "Reserve" available to meet them.

At the end of 1953 there will be three Underwriting Accounts, i.e. 1951, 1952, and 1953, and in all probability the former, as revised by 1953 Income and Claims, will be closed off, the underwriter re-insuring (as in the 1950 account) his possible claims against the 1951 account.

In the books the various accounts (Premiums, Claims, etc.) will be balanced off yearly and at the end of the third year finally written off.

The principle of "Re-insurance" is analogous to that of a bookmaker who, finding his book overloaded, that is to say, too much money on one horse, decides to "lay off" a proportion of his risk with a fellow bookmaker.

Illustration. The Gothic Line insured their fleet of liners at Lloyd's for £250,000 to cover the whole of 19... The rate was 6 per cent less brokerage 5 per cent, discount 10 per cent.

During the year S.S. *Rimini* was damaged and a claim was agreed at £3,200: in addition S.S. *Volturno* valued at £15,000 was lost and the claim agreed at that figure.

The brokers dealt with the claims (Collecting Commission 1 per cent).

Journalize the appropriate entries in the insured's books to give effect to the above and show brokers' account.

JOURNAL

	£	£
Insurance Account . . . . . . *Dr.*	13,575	
To Lloyd's Brokers		13,575
Premium on £250,000 at 6 per cent, *less* brokerage 5%, *ess* discount 10% per the following computation—		
Gross Premium . . . . . £15,000, Payable £15,000		
Less 5% Brokerage . . . 750		
Net Premium to Underwriter . . £14,250		
Out of which is allowed to Insured 10% thereof 1,425		
Payable: £13,575		
Lloyd's Brokers . . . . . . *Dr.*	18,200	
To Repairs Account		3,200
,, S.S. *Volturno* Account		15,000
Damage to S.S. *Rimini* and total loss of S.S. *Volturno* as claimed from underwriters.		
Collecting Commission . . . . . *Dr.*	182	
To Lloyd's Brokers		182
Collecting Commission of 1 per cent on settled claims *re* S.S. *Rimini* and S.S. *Volturno.*		

Dr. LLOYD'S BROKERS *Cr.*

	£		£
To Cash . . .	13,575	By Premium . . .	13,575
,, Claim for Damage S.S. *Rimini* .	3,200	,, Collecting Commission S.S. *Rimini* £32, S.S. *Volturno* 150	182
,, Claim for Total Loss S.S. *Volturno* .	15,000	,, Cash . . .	18,018
	£31,775		£31,775

Notes. (i) The Collecting Commission, which is a capital charge, should be written off.

(ii) No figure is given for book value of S.S. *Volturno*, but after writing off Depreciation for portion of year to date of loss, the balance of loss (after crediting £15,000 Claim) should be written off.

(iii) The amount of insurance is virtually £15,000, *less* Rebate £1,425 due to insured after the underwriter has paid out of the £15,000 the £750 Brokerage, i.e. 10 per cent on the remaining £14,250.

CHAPTER XXVII

STOCK EXCHANGE TRANSACTIONS—INVESTMENT ACCOUNTS—AND VALUATION OF SHARES

THE problems arising out of Stock Exchange transactions may be dealt with in the following sequence—

(*a*) Purchase and sale of investments.

(*b*) Treatment of dividends and interest.

(*c*) Brokers' Accounts.

Purchase and Sale of Investments. Where investments are purchased on the Stock Exchange, it is the practice to charge the buyer with brokerage (based on a graduated scale), stamp duty, transfer duty, registration fee, and the cost of the contract stamp. There are often additional stamp duties in the case of a company incorporated abroad, e.g. South Africa. The only expenses to the seller are the brokerage and the contract stamp, both of which are payable on every Stock Exchange transaction, whether a purchase or a sale. In the case of a sale, the expenses (brokerage and contract stamp) are *deducted* from the proceeds of realization of the investment.

Although the treatment and practice of the Stock Exchange is outside the scope of this book, the following observations are given so far as is necessary to enable the student to understand the calculations of Investment Accounts.

The operations on the Stock Exchange are carried on by its members who are either dealers—who actually buy or sell investments—or brokers, who merely act as intermediaries between the dealers and the public.

The price quoted by a dealer to the broker is not a single, but a double price, the one at which he is prepared to buy and the other to sell, as upon an inquiry from the broker he is not aware whether the latter wishes to buy or sell for his client. The lower figure is obviously the *dealer's buying price*, the higher his *selling price*, the difference being the "TURN."

Job lines or odd lots (as the market terms them) are blocks of shares other than in round figures (such as 50 or 100). They are expensive to buy, and on sale are likely to fetch poor prices.

The investor, except in the case of certain classes of stocks, pays for his purchases and receives cash in respect of his sales at the end of the "Account." There are twenty-four Accounts to the year, most of them being of fortnightly duration, the remainder being of three weeks.

Extract from Minimum Scale of Commissions (or Brokerage)

British Government Securities; British Electricity, Gas, Iron and Steel, and Transport Guaranteed Stocks; Dominion, Colonial and Indian Government Securities; London County Consolidated Stocks; County, Corporation, and Provincial Securities (British, Dominion, or Colonial); Public Boards (G.B. and N.I.) Inscribed and Registered Stocks; International Bank for Reconstruction and Development Stock.	⅜ per cent on Stock up to £10,000. ¼ per cent on Stock in excess of £10,000.
Bank of Ireland Stock; certain non-sterling Dominion and Colonial Bearer Bonds; County, Corporation, and Provincial Annuities.	⅜ per cent on *Money*.

Bonds to Bearer other than those included above	£1 or under	at discretion
	£5 ,,	$\frac{1}{32}$ per cent on Stock
	£10 ,,	$\frac{1}{16}$,, ,,
	£20 ,,	⅛ ,, ,,
	£50 ,,	¼ ,, ,,
	£75 ,,	⅜ ,, ,,
	£100 ,,	½ ,, ,,
	over £100	½ ,, on *Money*

Registered Stocks quoted per cent ,, Debentures and Bonds	¾ per cent on *Money*

In any case, the following minimum scale must be observed—

	£	s.	d.
If purchase consideration *less* than £20		5	0
If purchase consideration £20 or over and *less* than £100		10	0
If purchase consideration £100 or over	1	0	0

[1] Subject to this minimum, on changing investments for the same principal during the same or next Account, a broker may reduce his commission to not below half rate on the second transaction.

Shares or units of stock, registered or Bearer, other than certain Shares of U.S.A. and Canadian Companies—

	£	s.	d.		£	s.	d.	s.	d.	
Not exceeding		1	0							at discretion
Exceeding		1	0	and not exceeding		1	6		¼	per share or unit
,,		1	6	,, ,,		2	6		½	
,,		2	6	,, ,,		3	6		¾	,,
,,		3	6	,, ,,		5	0		1	,,
,,		5	0	,, ,,		10	0		1½	,,
,,		10	0	,, ,,		15	0		2¼	,,
,,		15	0	,, ,,	1	0	0		3	,,
,,	1	0	0	,, ,,	1	10	0		3¾	,,
,,	1	10	0	,, ,,	2	0	0		4½	,,
,,	2	0	0	,, ,,	2	10	0		6	,,
,,	2	10	0	,, ,,	3	0	0		7½	,,
,,	3	0	0	,, ,,	3	10	0		9	,,
,,	3	10	0	,, ,,	4	0	0		10½	,,
,,	4	0	0	,, ,,	5	0	0	1	0	,,
,,	5	0	0	,, ,,	7	10	0	1	3	,,
,,	7	10	0	,, ,,	10	0	0	1	6	,,
,,	10	0	0							¾ per cent on *Money*

[1] **During the War, there were no "accounts," all transactions being for Cash.**

Contract Stamps. For any purchase *or* sale of securities carried out for the general public, a proper contract must be rendered by the broker doing the business. Such contract must be properly stamped.

The scale of charges for contract stamps is as follows—

Where the value of the securities dealt in is—

	£		£	£	s.	d.
	5	and does not exceed	100		1	0
Exceeds	100	,, ,,	500		2	0
,,	500	,, ,,	1,000		4	0
,,	1,000	,, ,,	1,500		6	0
,,	1,500	,, ,,	2,500		8	0
,,	2,500	,, ,,	5,000		12	0
,,	5,000	,, ,,	7,500		16	0
,,	7,500	,, ,,	10,000	1	0	0
,,	10,000	,, ,,	12,500	1	4	0
,,	12,500	,, ,,	15,000	1	8	0
,,	15,000	,, ,,	17,500	1	12	0
,,	17,500	,, ,,	20,000	1	16	0
,,	20,000			2	0	0

TABLE OF STAMP DUTIES ON TRANSFER DEEDS

Consideration not exceeding £	£	s.	d.	Consideration not exceeding £	£	s.	d
5		2	0	125	2	10	0
10		4	0	150	3	0	0
15		6	0	175	3	10	0
20		8	0	200	4	0	0
25		10	0	225	4	10	0
50	1	0	0	250	5	0	0
75	1	10	0	275	5	10	0
100	2	0	0	300	6	0	0

On the consideration exceeding £300 the Stamp Duty is at the rate of £1 for every further £50 or fractional part of £50.

Transfer Duty on Nominal Consideration. In order that transfers may be accepted on nominal consideration which entitles the value to pass on a stamp of 10s., it is necessary that they shall fall strictly within the categories which enable them to be "adjudged duly stamped" by the Commissioners of Inland Revenue (see page 785).

Book-keeping Entries. If the question of interest and dividend be ignored, the entries in the books of the investor are: (1) debit Investment Account and credit broker with the total cost in case of a purchase; (2) debit broker and credit Investment Account with the net proceeds in case of a sale. Where the investment has been sold there will be a debit balance in the Investment Account if a loss has been incurred, which will be transferred to Profit and Loss Account or reserve; in case of a profit, the entries will be reverse to the above. In case of partial sale, the profit or loss thereon will be transferred in the manner to be indicated, and the balance of the investment at cost brought down at the end of the accounting period.

DIVIDENDS AND INTEREST

Difficulties arise, however, by reason of the fact that the buyer of an investment normally acquires the right to the next dividend, i.e. it is "cum dividend" unless the investment is purchased "ex dividend," so that in almost every case a part of the purchase price includes a portion of the accruing dividend. Hence, the dividend received after purchase is in reality not all income, but a part recoupment of the capital outlay, and a proportion should be credited to the cost of the investment. The same principle applies on a sale "cum dividend." In this case, part of the sale price is in reality income.

In order to overcome this difficulty the Investment Account is ruled with two columns on each side, one for capital and the other for income, and the following rules apply.

(1) Upon a purchase cum dividend being made, that part of the purchase price which relates to the dividend accruing *from* the date of the last dividend (or in the case of companies from the date of the last accounting period) to the date of purchase is debited in the income column; the balance in the capital column.

(2) Upon a sale cum dividend, that part of the sale price which relates to the dividend accruing [as in (1)] is credited in the income column; the balance in the capital column.

Illustration. X buys 1,000 7½ per cent preference shares on 30th April at 22s. cum dividend. Dividends are due on 1st January and 1st July. Ignoring expenses of purchase and income tax, show the Investment Account from 30th April until 1st July.

Dr. INVESTMENT *Cr.*

			Income			Capital						Income			Capital		
19..			£	s.	d.	£	s.	d.	19..			£	s.	d.	£	s.	d.
April 30	To Purchase (details), 1,000 7½% Preference Shares					1075	0	0	July 1	By Dividend for half year to date		37	10	0			
	" 4 Months' Dividend.		25	0	0												

On purchase, 4 months' accruing dividend included in the price, i.e. four-sixths of £37 10s., is debited in the income column. The net credit to income is £12 10s. being the dividend for the two months, 1st May to 30th June, i.e. two-sixths of £37 10s.

Conversely, in regard to sales, the whole proceeds are treated as capital, save for the dividend accruing for the period elapsing between the date of the last dividend and the date of sale.

Illustration. Assuming that the shares in the previous illustration were sold on 31st July at 20s. 6d. cum dividend, show the entries in the Investment Account relating to the sale.

Dr. INVESTMENT *Cr.*

			Income			Capital						Income			Capital		
			£	s.	d.	£	s.	d.	19..			£	s.	d.	£	s.	d.
									July 31	By Sale (details), 1,000 7½% Preference Shares					1,018	15	0
										" 1 Month's Dividend[1]		6	5	0			

In the case of fixed income stocks the price goes ex dividend usually BEFORE the dividend date, and the price reduction consequent upon the quotation being "ex" and not "cum" is the FULL period's dividend. It is important to realize the significance of this because the proceeds due to capital are too small by the interest accruing during the period elapsing between the sale and the dividend date, whilst income will obtain the FULL period's income in spite of the sale of the security before the expiry of such period. Similarly, upon a purchase ex dividend the capital cost is too small and income will receive the *first* dividend at the expiry of the succeeding period, although the investment was purchased BEFORE the commencement of such period.

In order to adjust the position arising out of the above the procedure is as follows—

(1) Upon a purchase ex dividend that part of the dividend which arises in the period elapsing between the date of purchase and that of the dividend is debited in the capital column and credited in the income column.

(2) Upon a sale ex dividend, that part of the dividend which arises in the period elapsing between the date of the sale and that of the dividend is credited in the capital column and the balance in the income column.

It should be noted that upon a sale ex dividend, the SELLER receives and retains the forthcoming dividend, the sale price having been reduced by such dividend. Further, the sale ex dividend is a sale "ex" the WHOLE dividend, not merely the accruing dividend, hence the receipt by capital is too small, thus necessitating the above apportionment.

Illustration. X sells £1,000 6 per cent Government Stock at par. How will the seller and buyer respectively deal with the transaction? Dividends are due on 1st June and 1st December.

Suppose for simplicity the "true" value of the stock *without* dividend is always at par, then the price "cum dividend" would be (ignoring tax)—

[1] At the date of sale there is one month's dividend included in the price, i.e. $\frac{1}{6}$ of £37 10s.

		£
On Dec. 1		100
,, Jan. 1		100½
,, Feb. 1		101
,, March 1		101½
,, April 1		102
,, May 1		102½
,, ,, 30	(Just prior to the dividend.)	103

On 1st May or thereabouts the stock would be marked x.d. (i.e. ex dividend) and will therefore be reduced by the FULL half year's dividend of[1] £3, leaving the x.d. price at 99½. Suppose the holder sold on that date he would still receive his £102½, but in the form of sale price £99½ and dividend received a month later £3, whereas the true price is £100, and income accruing amounts to £2 10s. In order, therefore, to make the accounts correct, upon the receipt of the dividend of £3, income column will be credited with £2 10s. and capital column with 10s., bringing the total capital credit to £100, i.e. par, and leaving income with a credit of £2 10s.

The amount of 10s. is that part of the dividend arising in the period elapsing between the date of sale (1st May) and the due date of the dividend (1st June) i.e. one month on £100 at 6 per cent per annum. As the stock is sold, income is entitled only to five months' dividend (1st December to 1st May) i.e. five months on £100 at 6 per cent per annum = £2 10s., and as the apportionment of income is that sum, the accounts show the true state of affairs.

Conversely, as regards the buyer, it is clear that the true purchase price is £100, therefore he could debit 10s. in the capital column and credit income column.

On 1st December the buyer will have held the stock for seven months, so that the credit to income should amount to £3 10s. This, in effect, is made up as follows: (*a*) the above 10s. transferred, and (*b*) the £3 received on 1st December in respect of the half-yearly dividend. In other words, the buyer entirely misses the dividend for the month of May, but his purchase price is reduced accordingly. It will be seen that the "marking down" unduly deflates the true price by the dividend due between the marking x.d. and the date on which the dividend is paid—in the above instance, one month.

The accruing interest to be brought down where a sale x.d. has taken place is ascertained as follows—

(1) Interest from the date of the last payment to the date of balancing the account on the part retained, and interest from the date of the last payment to the date of sale on the part sold; or

(2) Interest from the date of the last payment to the date of balancing the account on the part retained, plus interest from the date of the last payment to the date of the next payment on the part sold, less the interest from the date of sale to the date of the next payment on the part sold; or

[1] For the present purpose income tax is ignored.

(3) Interest from the date of the last payment to the date of balancing the account on the part retained and the part sold ex dividend, less interest on the latter from the date of balancing the account back to the date of the sale ex dividend.

Illustration. A buys £10,000 3 per cent Government Stock at 85 on 5th October, 1952, and sells £6,000 at 84 on 28th March, 1953. Interest dates are 5th October, 5th January, 5th April, and 5th July. Accounts are to be made up to 31st March, 1953. Show Ledger Account in respect of the above, ignoring income tax, brokerage, etc. Applying method (1) above—

(*a*) Interest to date of balancing the account on the part retained, i.e. £4,000 at 3 per cent per annum for 85 days.

		£	s.	d.
$\frac{85}{90}$ × £30		28	6	8
Add one quarter's Interest on £6,000 at 3% per annum	£45			
Less $\frac{8}{90}$ × £45	4			
		41	0	0
		£69	6	8

(*b*) Interest on £4,000 plus £6,000, i.e. £10,000 at 3 per cent per annum for 85 days.

	£	s.	d.
$\frac{85}{90}$ × £75	70	16	8
Less Interest on £6,000 at 3% per annum for 3 days, $\frac{3}{90}$ × £45	1	10	0
	£69	6	8

The balance retained is $\frac{4}{10}$ × £8,500 . . £3,400

The loss on realization is—

Cost of £6,000, i.e. $\frac{6}{10}$ of £8,500	£5,100	
Less Sale	5,044	
		£56

The interest is as follows—

	£	s.	d.
On £10,000 from Oct. 6, 1952, to Jan 5, 1953	75	0	0
On £10,000 from Jan. 6, 1953, to March 28, 1953, $\frac{82}{90}$ × £75	68	6	8
On £4,000 from March 29, 1953, to March 31, 1953, $\frac{3}{90}$ × £30	1	0	0
	£144	6	8

The same result is obtained by applying rules shown in paragraphs (2) and (3).

Government Stock

Dr.

Date	Particulars		Nominal £	s.	d.	Income £	s.	d.	Capital £	s.	d.
1952 Oct. 5	To Cash: Purchase at 85		10,000	0	0				8 500	0	0
1953 Mar. 31	,, Interest on Investments Account .					144	6	8			
		£	10,000	0	0	£144	6	8	£8,500	0	0
April 1	To Balance . . .	b/d	4,000	0	0				3,400	0	0
	,, ,, . .	b/d				69	6	8	4	0	0

Cr.

Date	Particulars		Nominal £	s.	d.	Income £	s.	d.	Capital £	s.	d.
1953 Jan. 5	By Interest for quarter year to date .					75	0	0			
Mar. 28	,, Cash: Sale at 84 .		6,000	0	0				5,040	0	0
	,, Interest on £6,000 sold *Ex. Div.* Mar. 28 to April 5 [$\frac{8}{90}$ × £45] . . .	c/d							4	0	0
31	,, Balance, Interest Accruing on £6,000 from Jan. 6 to Mar. 28 [$\frac{82}{90}$ × £45][1] .	c/d				41	0	0			
	,, [1]Interest Accruing on £4,000 from Jan. 6 to Mar. 31 [$\frac{85}{90}$ × £30] . . .	c/d				28	6	8			
	,, Loss on Sale . .								56	0	0
	,, Balance, Stock [$\frac{4}{10}$ × £8,500] . .	c/d	4,000	0	0				3,400	0	0
		£	10,000	0	0	£144	6	8	£8,500	0	0

[1] According to rule in paragraph (1) on page 1137.

If the remaining stock is sold on 5th April, 1953, at 86, the account will be closed thus—

Dr. GOVERNMENT STOCK *Cr.*

			Interest £	s.	d.	Capital £	s.	d.				Interest £	s.	d.	Capital £	s.	d.
1953 April 1	To Balance .	b/d				3,400	0	0	1953 April 5	By Interest on £10,000 at 3% p.a. for quarter to date .		71	0	0	4	0	0
	" "	b/d	69	6	8	4	0	0		" Cash—Sale of £4,000 Stock at 86. .					3,440	0	0
5	" Profit on Sale .					40	0	0									
	" Interest on Investments Account[1] .		1	13	4												
			£71	0	0	£3,444	0	0				£71	0	0	£3,444	0	0

If part only is sold, say £1,000, the remaining balance would be brought down at $\frac{3,000}{4,000} \times$ £3,400 (or $\frac{3,000}{10,000} \times$ £8,500) = £2,550.

Illustration. On 1st June, 1952, Scarsdale Investment Trust, Ltd., held £10,000 6 per cent Queensmania Stock standing in the books at £9,560. Interest is payable on 31st July and 31st January. On 1st September, 1952, a further £5,000 of the stock was bought at 98 cum dividend and on 1st January, 1953, a further £4,000 of the stock was bought at 97 x.d.

On 31st March, 1953, £8,000 of the stock was sold at 101 c.d., and on 15th June, 1953, £6,000 of the stock was bought at 99½ x.d., and on 30th June, £2,000 of the stock was sold at 99½ x.d. Show the Investment Account for the period ending 30th June, 1953.

Ignore Income Tax and Expenses.

The amount to credit of Interest Account, £915 is made up as follows—

£		£	s.	d.
10,000—June 1 to Sept. 1, 3 months at 6% p.a.	.	150	0	0
15,000—Sept. 1 to Jan. 1, 4 months at 6% p.a. .	.	300	0	0
19,000—Jan. 1 to Mar. 31, 3 months at 6% p.a. .	.	285	0	0
11,000—April 1 to June 15, 2½ months at 6% p.a.	.	137	10	0
[2] 17,000—June 15 to June 30, ½ month at 6% p.a.	.	42	10	0
		£915	0	0

Where many investments are held, a schedule will be prepared showing the cost price and current price of each investment. Care must be exercised in the compilation of the current price because the market price, except where quoted x.d. will include the accrued and accruing dividend or interest.

[1] The above amount is Interest on £4,000 at 3 per cent per annum for 5 days, i.e. $\frac{5}{90} \times$ £30.

[2] £17,000 is the nominal amount of Stock held until the very last day of the period, when £2,000 was sold, leaving £15,000.

Dr. 6% QUEENSMANIA STOCK Cr.

Date	Particulars		Nominal	Income	Capital
1952			£	£	£
June 1	To Balance	b/d	10,000		9,560
	,, Balance, accruing interest for four months	b/d		200	
Sept. 1	,, Cash: Purchase at 98 *Cum. Div.*, £4,900		5,000		
	Capital				4,875
	Income 1 month (Aug. 1 to Sept. 1)			25	
1953 Jan. 1	,, Cash: Purchase at 97 *Ex. Div.*, £3,880		4,000		
	Capital				3,880
	Interest transferred to *Contra* (Jan. 1 to Jan. 31)				20
June 15	,, Cash: Purchase at 99½ *Ex. Div.*, £5,970		6,000		
	Capital				5,970
	Interest transferred to *Contra* (June 15 to July 31)[2]				45
30	,, Interest Account			915	
	,, Profit and Loss Account: Profit on Sale				260
			£25,000	£1,140	£24,610
July 1	To Balance	b/d	15,000	245	14,610
	,, ,,	b/d			10

Date	Particulars		Nominal	Income	Capital
1952			£	£	£
July 31	By Half year's Interest to date			300	
1953 Jan. 1	,, Transfer from *Contra*			20	
31	,, Interest on £15,000 at 6% p.a. for half year			450	
Mar. 31	,, Cash: Sale at 101 *Cum. Div.*, £8,080		8,000		
	Capital				8,000
	Income 2 months, Feb. 1 to March 31			80	
June 15	,, Transfer from *Contra*			45	
30	,, Cash: Sale at 99½ *Ex. Div.*, £2,000		2,000		
	Capital				1,990
	Interest: 1 month, June 30 to July 31	c/d			10
	,, Balance, Accruing Interest . £275[1] *Less* Adjustment . 30	c/d		245	
	,, Balance Capital— $\frac{15,000}{25,000}$ × £24,350	c/d	15,000		14,610
			£25,000	£1,140	£24,610

[1] The balance of Interest is calculated—

	£
Interest from last payment to balancing the account, £11,000 × $\frac{5}{12}$ × $\frac{6}{100}$ on the part retained and the part sold *Ex Div.*, i.e. £10,000 plus £5,000 plus £4,000 *less* £8,000	275
Less Interest on the latter from the date of balancing the account back to the date of the sale *Ex Div.*	Nil
	275

[2] The £30 adjustment is required as the transfer of £45 is for 1½ months to 31st July, whereas the period relates to ½ month to 30th June, i.e. £15 . . . 30

£245

Where there are several operations in one investment the average cost of the balance remaining is taken into account, the balance of the capital column being transferred as a profit or loss to Profit and Loss on Investment Account.

The most cautious rule to adopt is—

(1) To treat each transaction as a separate one in case of **loss.**

(2) To treat the transactions as a whole in case of **gain.**

Illustration. G. Ambler held the following investments on 1st January, 19..—

	Cost			Sold during Year for		
	£	s.	d.	£	s.	d.
£500 5% Japanese Bonds (1907)	70	13	0	90	12	0
100 Beautility Furniture Ordinary	169	8	6	221	4	0
100 Bleachers' Ordinary	105	3	6	113	14	0
100 Courtney Pope Ordinary	115	3	6			
20 International Nickels	180	11	0			
500 Black and Blue Ordinary	139	3	6	50	9	11
				(250 only)		
During the year he purchased—						
200 Charterhouse Investment Ordinary	139	3	6			
500 Amalgamated Bankets	94	18	0			

All the above are after dealing with Brokerage (as per Broker's Contract Notes).

The object of the transactions was gain by way of appreciation. Ignoring expenses and dividends, prepare Investments Trading Account. (See page 1143.)

Brokers' Accounts. The main entries in the broker's books are—

Upon a purchase for a client—

(1) Debit Client with—

(*a*) Cost of Security purchased, and

(*b*) Brokers' Commission thereon; and

Credit Dealer with (*a*) and Commission Account with (*b*).

(2) Debit Client with—

(*a*) Contract Stamp and Credit Contract Stamps Account;

(*b*) Transfer Duty and Credit Transfer Stamps Account;

(*c*) Registration fee and credit cash.

Upon a sale for a client—

(1) Debit Dealer with—

(*a*) Cost of Security sold, and Credit Commission Account with (*b*) Broker's Commission thereon and credit client with the net excess of (*a*) over (*b*).

In practice a Contract Journal will be employed for the entries for purchases and sales.

Dr INVESTMENTS TRADING ACCOUNT **Cr**

Dr		£	s	d	£	s	d
To Opening Stocks—	b/f						
£500 5% Japanese Bonds 1907		70	13	0			
100 Beautility Furniture Ordinary		169	8	6			
100 Bleachers Ordinary		105	3	6			
100 Courtney Pope Ordinary		115	3	6			
20 International Nickels		180	11	0			
500 Black and Blue Ordinary		139	3	6			
					780	3	0
" Purchases—							
200 Charterhouse Investment Ordinary					139	3	6
500 Amalgamated Bankets					94	18	0
" Net Profit (per Contra)					61	3	2
					£1 075	7	8
To Opening Stocks—	b f						
100 Courtney Pope Ordinary		115	3	6			
20 International Nickels		180	11	0			
250 Black and Blue Ordinary		69	11	9			
200 Charterhouse Investment Ordinary		139	3	6			
500 Amalgamated Bankets		94	18	0			
					599	7	9

Cr		Loss £	s	d	Gain £	s	d	£	s	d
By Sales—										
£500 Japanese Bonds, 1907					19	19	0	90	12	0
100 Beautility Furniture Ordinary					51	15	6	221	4	0
100 Bleachers' Ordinary					8	10	6	113	14	0
250 Black and Blue Ordinary		19	1	10				50	9	11
		19	1	10	80	5	0			
Net Profit		61	3	2						
		£80	5	0	£80	5	0			
" Closing Stocks	c/f							599	7	9
								£1 075	7	8

Note The treatment of the sale of half the holding of 500 Black and Blue is Cost of 250 – ½ × £139 3s 6d = £69 11s 9d as against price realized therefor, £50 9s 11d.

As regards the profit on sale of part of a holding, it may be dealt with on similar lines or used to ' average down" the remaining part, thus not bringing into credit *any* profit till the original outlay is recovered e g assuming 50 Courtney Pope Ordinary Shares were sold for £70, the profit would be £70 – £57 11s 9d [i e ½ × £115 3s 6d] viz £12 8s 3d and £57 11s 9d brought down or taking the sale price of £7 to reduce the cost of the unsold part to £45 3s 6d When the remaining shares are sold, the final result will be the same, as shown below (assuming the sale price thereof at £60)—

(1) Where profit credited on each sale

	£		£	s	d
Sale of 50 (1st Sale)	70	Profit	12	8	3
Sale of 50 (2nd sale)	60	Profit	2	8	3

(2) Where no profit credited till original capital recouped

	£		£	s	d
1st Sale	70	Profit	*nil*		
2nd Sale	60	Profit	14	16	6 [£60 — £45 3s 6d]

[i e Sale £130 – Cost £115 3s 6d]

Illustration. A Broker carried out the following instructions for clients—

From A. Purchase of 200 Taylor Woodrow Ordinary Shares at 14s. 6d.
„ A. Purchase of 100 Brakpan Mines Shares at 16s.
„ B. Sale of 200 Imperial Tobacco Ordinary Shares at £5.
„ C. Purchase of 1,000 Castlefield Rubber Shares at 2s.
Sale of 500 British Controlled Common Shares at 12s.

CONTRACT JOURNAL

Date	Name of Party	Description of Security	Price						Name of Party	Description of Security	Commission					
			£	s.	d.	£	s.	d.			£	s.	d.	£	s.	d
	A	200 Taylor Woodrow Ordinary .		14	6	146	17	6	Dealer		1	17	6	145	0	0
	A	100 Brakpans .		16	0	81	5	0	Dealer		1	5	0	80	0	0
	Dealer		5	0	0	1,000	0	0	B	200 Imperial Tobacco Ordinary .	10	0	0	990	0	0
	C	1,000 Castlefield Rubber .		2	0	102	1	8	Dealer		2	1	8	100	0	0
	Dealer			12	0	300	0	0	C	500 British Controlled Commn. .	4	13	9	295	6	3
						£1,630	4	2			£19	17	11	£1,610	6	3
						(1)					(2)			(3)		

(1) Each item debited to dealer or client.
(2) Total posted to credit of Commission Account.
(3) Each item credited to dealer or client.

The registration fees, transfer duties and contract stamps may be incorporated in the Contract Journal but are often put through a Fees and Stamp Journal (debt to client: credit to cash for Registration fees and respective stamp accounts for Transfer Duties and Contract Stamps).

In the case of a reinvestment order, i.e. a purchase and sale of a security (not being the *same* Stock or Share) through the same broker in the same account, the broker is *permitted* to charge a reduced commission, viz. one half on the transaction attracting the smaller consideration, or, if necessary, on part of the larger bargain.

In the foregoing transaction the broker may charge a reduced commission viz. $\frac{1}{4}$d. a share on 1,000 Castlefield Rubber Shares amounting to £1 0s. 10d. instead of $\frac{1}{2}$d. a share (but in no case may the commission be less than the minimum of 5s., 10s., or £1 mentioned on page 1133).

Illustration. The commission permissible on a reinvestment is shown at the top of page 1145.

There will be entries in connection with collecting dividends for clients where securities have been *purchased* cum dividend and the dividend paid before registration of transfer; and collecting dividends from clients where in similar circumstances a client has *sold* securities; costs of split transfers, etc., but these are straightforward and call for no special mention here.

	£ s. d.	£ s. d.
Sale of £1,000 Government Stock at par . . .		1,000 0 0
Less Commission—⅜% on Stock		3 15 0
		£996 5 0
Reinvested in—		
Purchase of 600 Shares at 20s. . .		600 0 0
Add Commission at 3d. . . .	7 10 0	
Less ½ Commission—£600 Stock		
[i.e. $\frac{3}{16}$% on £600] . . .	1 2 6	
		6 7 6
		£606 7 6

If total accounts are employed, the normal subdivision of Bought and Sales Ledger will be impracticable as clients and dealers will be buyers and sellers so that the Ledgers will be subdivided into (*a*) Clients and (*b*) Dealers.

Private Investment Accounts. Where a private individual has a number of investments (including property), accounts should be kept systematically.

The special features of these accounts are—

(1) Adequate accounting of investments and property, either as part of double entry or in memorandum with complete details of such investments, sales, purchases, income and expenses attributable to each, with a special column to record tax suffered or paid on assessments; the latter will normally comprise Sch. A, Sch. D, Case VI for excess rents, etc., Case III for Bank Deposit Interest and other untaxed Interest, Case IV for income from Foreign and Colonial Securities, e.g. Mortgages and Bonds and Case V for Foreign and Colonial possessions, e.g. foreign Bank Interest and Dividends.

(2) If the properties are substantial a Rental Register or Ledger with full details as to tenants' names, addresses of properties, nature of letting, rents receivable, rents paid, arrears column, void column (for empty or damaged property), outgoings, etc., rates if landlord liable, chief rents, agent's commission, etc.

(3) Profits and Losses on Sales (after deduction of legal costs of acquisition) are capital and not normal revenue profits and losses. (The cost of acquisition, e.g. brokerage, and stamp duty on Stocks and Shares will be debited to the cost of the asset.)

(4) All income taxed at source should be raised to gross and debited as a separate item to Revenue—conversely for tax deducted from charges of a Revenue nature, e.g. Chief Rents, Loan Interest, etc. (Bank and Brokers' Interest excepted, no tax being deductible). Alternatively, these tax adjustments may be debited or credited to Drawings, but it is considered preferable to record them in Revenue, so that the tax charge can be readily seen.

(5) As to depreciation, it is a matter of choice, so long as consistency is adopted. Generally speaking, it is preferable to record depreciation by means of a debit to Capital Account, and a credit

to a Depreciation Account, against which may be credited any future appreciation provided that the same account be used should, the appreciations exceed the Depreciation Account—in other words—if fluctuations are to be recorded they should be done year by year in one continuous account. [As the individual is considered an investor and not a speculator, the fluctuations in values should be regarded as affecting Capital.]

Illustration. The following are the balances of Jones at 31st March, 19. . (details of properties being shown in the schedule on page 1147)—

	Dr. £	Cr. £
Dividends and Interest received, including Untaxed Int. £80		1,080
Rents received (payable half-yearly, 31st Mar. and 30th Sept.)		463
Chief Rents received		55
Outgoings paid, including Tax assessed and paid	242	
Broker *re* Purchase of Investments		850
Depreciation Account, 1st April, 19. .		3,600
Capital, 1st April, 19. .		55,454
Losses and Profits on realization of Investments	8,000	3,000
Investments at cost (market value £35,100)	37,000	
Properties at cost	9,000	
Receivable Chief Rents at cost	2,800	
Rents accruing, net, at 1st April, 19. .	45	
Chief Rents accruing, net, at 1st April, 19. .	15	
Cash at Bank—Deposit	4,500	
Cash at Bank—Current	1,800	
Drawings	1,100	
	£64,502	£64,502

Make provisions for net chief rents accruing £20; net rents accruing £70; outgoings £70 (repairs).

Prepare Investment Revenue Account for the year ended 31st March, 19. ., and Balance Sheet at that date. (The untaxed interest is the same as the previous year and no Income Tax is owing.) Take Income Tax at 10s.

Investment Revenue Account for the Year ended 31st March, 19. .

	£	£	£		£	£
To Outgoings on Properties (£242 + £70 − £40 − £57)			215	By Dividends and Interest, net	1,000	
,, Income Tax—Tax deducted:				*Add* Income Tax deducted	1,000	
Dividends and Interest	1,000					2,000
Rents (Schedule A)	232			,, Interest receivable—Gross		80
Chief Rents	60			,, Rents receivable—Net [£463 + £70 − £45]	488	
		1,292		*Add* Income Tax deducted	232	
,, Income Tax—Tax paid:						720
Interest (Case III, Sch. D)	40			,, Chief Rents—Net [£55 + £20 − £15]	60	
Excess Rents (Case VI, Sch. D)	57			*Add* Income Tax deducted	60	
		97				120
			1,389			
,, Surplus to Capital			1,316			
			£2,920			£2,920

BALANCE SHEET AS AT 31ST MARCH, 19..

	£	£	£		£	£
Creditors—				Properties at Cost . . .		9,000
Repairs		70		Investments at Cost . . .		37,000
Broker		850		Receivable Chief Rents at Cost .		2,800
			920	Debtors for Rent—Net .	70	
Depreciation Account[1] at 1st April, 19.. . .		3,600		Debtors for Chief Rents .	20	
Less Transfer to Capital		1,700				90
			1,900	Cash at Bank—		
Capital Account at 1st Apr., 19..		55,454		Deposit	4,500	
Less Loss on Investments Sold	8,000			Current	1,800	
Less Profit on Investments Sold	3,000					6,300
	5,000					
Deduct Decrease on Depreciation Account .	1,700					
		3,300				
		52,154				
Add Surplus for Year .	1,316					
Less Drawings . .	1,100					
		216				
			52,370			
		£	55,190		£	55,190

SCHEDULE OF RENTS AND INCOME TAX

	Annual Rents	G.A.V.	Statutory Repairs Allowance	Void Claim	N.A.V.	Notional G.A.V. (= Rents)	Notional Repairs Allowance	Notional N.A.V.	Actual N.A.V.	Excess
	£	£	£	£	£	£	£	£	£	£
Property 1 . .	140	130	25	—	105	140	27	113	105	8
" 2 . .	100	100	20	—	80	100	20	80	80	—
" 3 . .	60	50	10	—	40	60	12	48	40	8
" 4 . .	90	60	12	—	48	90	18	72	48	24
" 5 . .	122	90	18	—	72	122	23	99	72	27
" 6 . .	28	20	5	—	15	28	7	21	15	6
" 7 . .	50	32	8	—	24	50	10	40	24	16
" 8 . .	130	100	20	—	80	130	25	105	80	25
" 9 . .	Empty	60	12	48	—	—	—	—	—	—
	£720	£642	£130	£48	£464[2]	£720	£142	£578	£464	£114[3]
			$\underbrace{\qquad\qquad\qquad\qquad}_{£642}$							

If the accounting period ended otherwise than on 31st March, there would be provisions for taxation in respect of the properties, either accruing or having been paid by the tenants. The possibility of a maintenance claim in respect of the properties has been ignored.

Assuming the above year was to 31st March, 1952 [actually the standard rate of Income Tax in that year was 9s. 6d.] any liability for Sur-tax for the year 1949-50 would have been paid on 1st January, 1951. There would be a liability for Sur-tax for 1950-51—assuming Jones's income for that year exceeded £2,000; although

[1] Alternatively may be deducted from the assets.
[2] Tax £232, payable by tenants and deducted from next rents.
[3] Tax £57, assessable directly on landlord.

it would not become payable till 1st January, 1952, a provision therefor might have been made at 1st April, 1951. The payment thereof on 1st January, 1952, would be debited to that provision.

Likewise at 31st March, 1952, a provision would be required for 1951-52. This liability would be based on the current income ("grossed" in the case of taxed income) except that the untaxed income would be based on the previous year (apart from the exceptions arising in the "early" and "closing" years).

As there is no change in the current year in respect of untaxed income the assessment for Sur-tax 1951-52 (payable 1st January, 1953) is—

	£
Taxed Dividends—gross current year's income	2,000
N.A.V. of Properties—current year's income	464
Excess Rents of Properties—current year's income	114
Chief Rents—gross current year's income	120
Untaxed Interest—preceding year's income	80
	£2,778

	£		£ s. d.
Liability for Sur-tax—	2,000		—
	500	at 2s.	50 0 0
	278	at 2s. 6d.	34 15 0
	£2,778		£84 15 0

Private Accounts. Private Accounts are sometimes written up from a viewpoint of taking all Income less all Outgoings, so that personal expenses (including Tax) will be regarded as appertaining to the Income and Expenditure Account, leaving the balance as a surplus or deficiency for the year.

The expenditure on Household might be further analysed, but it is probable that in most circumstances household personnel would not or could not keep reliable records of such expenditure.

Illustration. X has the following private Trial Balance at 30th June, 19..—

	£	£
Cash at Bank	1,700	
Household Expenses	500	
Other Expenses, Rates, etc.	150	
Investments	6,520	
Business Account	6,800	900
Investment Income		270
Property (house in own occupation, N.A.V. £40)	1,000	
Speculation Loan Account	16,300	
Capital		33,100
Insurance Policies	1,300	
	£34,270	£34,270

The business account contains the following items—

	£		£
To Drawings	900	By Capital	6,800
„ Balance	7,300	„ Profit	1,400
	£8,200		£8,200

The assets comprise Cash at Bank, £4,120; Fixtures, £100; Debtors, £3,400; and Creditors are £320.

The Speculation Account represents the amounts advanced to provide a separate set of operations for speculation purposes, the yearly profits or losses on realizations being transferred to Investment Reserve; any dividends received on speculation holdings are to be applied against Bank Interest paid, the net balance thereof being transferred to Investment Reserve.

Shares held at the close are taken into the Balance Sheet at cost.

The Trial Balance at 30th June, 19.. is—

	£	£
Investments at Cost	22,980	
Profit on Sales of Investments		1,800
Bank Interest Paid	80	
Bank Overdraft		3,000
X Private Account		16,300
X Bank Account (for Dividends)	90	
Investment Reserve		2,700
Dividends		90
Broker for Shares Sold	740	
	£23,890	£23,890

Two per cent per annum is added each year to the Insurance policies. At the date of the above Trial Balance the balance in the books represents the accumulated premiums and interest to the end of the preceding year and the premium for the current year.

Account has to be taken of the net annual value of the house X occupies, as representing "Rent."

There are no outstanding liabilities; accrued dividends are ignored and Income Tax is to be ignored.

Show—

(i) Income and Expenditure Account for the year ended 30th June, 19..;

(ii) Private Balance Sheet at that date; and

(iii) Combined Balance Sheet at that date.

Income and Expenditure Account for the Year ended 30th June, 19..

	£		£
To Household Expenses	500	By Business Profit	1,400
,, Other Expenses	150	,, Dividends	180
,, Rent per Contra	40	,, Rent per Contra	40
		,, Interest on Insurance Policy	26
,, Surplus	956		
	£1,646		£1,646

Balance Sheet as at 30th June, 19..

	£	£		£
Capital—			Investments at Cost	6,520
1st July, 19..	33,100		Speculation Account	16,210
Add Surplus	956		Property at Cost	1,000
		34,056	Insurance Policies	1,326
			Business Account	7,300
			Cash at Bank	1,700
		£34,056		£34,056

X Combined Balance Sheet as at 30th June, 19..

	Business	Private	Speculation	Total		Business	Private	Speculation	Total
	£	£	£	£		£	£	£	£
Capital		34,056		34,056	Investments		6,520	22,980	29,500
Investment Reserve [£2,700 +£1,800+£10]			4,510	4,510	Speculation		16,210		
					Property		1,000		1,000
					Insurances		1,326		1,326
					Business		7,300		
Creditors	320			320	Fixtures	100			100
Bank Overdraft			3,000		Debtors	3,400		740	4,140
Current Accounts	7,300		16,210		Cash at Bank	4,120	1,700		2,820
	£7,620	£34,056	£23,720	£38,886		£7,620	£34,056	£23,720	£38,886

Notes. (i) The debit of £90 (see Trial Balance) is transferred to the Loan, and the debit of £80 offset against Dividends received and transferred to Investment Reserve.

(ii) As to whether the Bank overdraft can be set off against Cash at bank depends on circumstances. If it is an overdraft granted by a bank other than that (or those) in which X is in credit, it cannot be set off: otherwise it may be set off, subject to contrary agreement, and furthermore X could claim it to be part of one combined account for interest purposes.

VALUATION OF SHARES

One of the most perplexing problems that confront accountancy students is that of valuation of shares. The underlying principles are by no means difficult, but their application calls for a considerable knowledge of technical points.

Shares, as the student will be fully aware, are of varying classes,

and the appellation ascribed thereto is by no means an unerring guide to their true nature. The types are usually classified into preference (or preferred), ordinary and deferred; but it is impossible to measure their true characteristics, qualities or defects unless detailed information is at hand which discloses to what extent the shares are covered in relation to capital and revenue, quite apart from voting rights and other important factors. A preference share, for instance, may be cumulative or non-cumulative; it may be a participating preference share, i.e. in addition to entitling the holder to the prior right to dividend at a fixed rate, it carries the right to participate further in the distributable profits of the company.

Ordinary shares are usually distinguished from preference shares in that they carry no priorities as to dividends and/or capital, obtaining (subject of course to suitable allocations to reserves) the right to the remaining profits, when they are distributed.

A detailed consideration of all the shades of difference between each class is impossible in this work; and attention will be given to the more usual significance involved in the terms employed.

The necessity for a valuation arises, *inter alia*, in the following circumstances.

(1) For estate duty purposes.

(2) For amalgamation and absorption schemes.

(3) For the valuation of the assets of the Balance Sheet of Trust and Finance Companies.

(4) For security margin purposes, e.g. where a bank lends money on the security of shares.

(5) For the discharge of debts and liabilities, in exceptional cases.

(6) For equilibrium purposes where it is necessary to avoid having too great a proportion of any one type of share.

(7) For the valuation of a "Fixed" Trust unit.

(8) Purchasing shares for control.

In most instances the valuation will be readily ascertained from the published price where the securities are quoted or dealt in on the recognized Stock Exchanges. Where, however, the securities either—

(*a*) are rarely dealt in on the Stock Exchange,

(*b*) are not quoted or dealt in at all,

recourse must be had to the preparation of a valuation.

In practice, an infinite number of technical points and market factors will affect the true valuation of shares, particularly as more than one factor may be operative at the same time.

Income Basis. It is clear that the normal purpose of the contemplated purchase is to provide for the buyer an annuity; for his outlay he will expect a yearly income return, great or small, stable or fluctuating, but nevertheless some sort of return commensurate with the price paid therefor. In other words, the investment is made, primarily at all events, with a view to providing a recurring income. Apart from the fact that he may cherish a hope that when the time arrives for selling he will be able to secure a profit, the purchaser's

object in making the purchase is to secure, as already stated, a recurring income; he is prepared to risk fluctuation and even the possibility that in any one year (or even years) no income at all will be forthcoming; but all the same he expects income, again hoping that it will as time goes on tend to increase rather than decrease.

To the ordinary shareholder the benefits (sometimes illusory) of stability and comparative certainty supposed to be inherent in the preference share do not appeal. The same principle of valuation exists for both classes of shares—preference and ordinary—although the considerations affecting the yield required differ considerably. This fundamental point will now be stated and illustrated.

The value of a share is arrived at by taking the rate of annual return divided by the return expected and multiplied by the par or paid up amount of the share upon which the dividend is based, without taking into account any accruing dividend. This sounds a very forbidding calculation, but it is not such an alarming proposition after all, as can now be seen.

For simplicity, take three companies all paying 15 per cent dividend on their ordinary shares of £1, and all of the class whereby an investor expects (say) 6 per cent annual return on his outlay; but the first company's shares are fully paid and the second and third 10s. paid. The second company has adopted Table A, and the third company's articles state that dividends are payable on the nominal value. The share valuations would be—

Company 1 $\frac{15}{6} \times £1 \quad = £2\ 10s.\ 0d.$

Company 2 $\frac{15}{6} \times 10s. = £1\ 5s.\ 0d.$

Company 3 $\frac{15}{6} \times £1 \quad = £2\ 10s.\ 0d.$

The calculation in the case of the second company is based upon the *paid up* value by reason of the fact that Table A stipulates that dividends are payable on the paid up value of a share. The above prices, it will be seen, are sufficient to give the purchaser his expected 6 per cent on the basis of a 15 per cent dividend. For example, Jones buys 1,000 shares in company number 1 costing £2,500. He therefore receives, assuming no change in the future, £150, which is 6 per cent on £2,500.

The circumstances may be such that when the purchaser acquires his share the dividend has just become payable, so that shortly after the purchase he would receive his £150 by way of dividend (and thus a part return of his capital outlay). Hence, in these circumstances the price would be for 1,000 shares £2,500 plus £150 = £2,650. When he receives his £150 dividend, the purchaser is left with a net cost of £2,500, being the true cost of his shares according to the facts indicated.

The position may be symbolized as follows—

The estimated price of a share ex dividend is

$$\frac{\text{Yield}}{\text{Risk}} \times \text{Basic denominator of share.}$$

For example, a company has shares of 5s. each fully paid, the rate of dividend being 45 per cent and the expected yield $5\frac{1}{2}$ per cent. The ex dividend price will be therefore—

$$\frac{45}{5\frac{1}{2}} \times 5\text{s.} = \frac{90}{11} \times 5\text{s.} = \text{(say) } \underline{\underline{41\text{s.}}}$$

Before proceeding to the next and probably most difficult stage, it may be a matter of interest to know the calculation in the case of American Common Stocks where (as is usual) stocks are of no par value, so that dividends cannot be expressed in terms of a percentage, but in terms of dollars and/or cents.

The symbolized calculation is—

$$\frac{100}{\text{Risk}} \times \text{Dividend in terms of dollars.}$$

For example, Amplifiers, Inc. pay $8 dividend annually and the yield expected is (say) 5 per cent. The estimated price ex dividend is

$$\frac{100}{5} \times \$8 = \$160$$

It will be clear that, inasmuch as there is a yearly return of $8 for an expenditure of $160, the expected yield is attained.

So far it has been postulated that a share attracts a certain yield —the investor, that is, requires or expects a minimum yearly return from the investment he has made. This minimum yield is not a static figure; it varies considerably at different times and is therefore a somewhat fluctuating, although extremely important factor. Despite this, its determination is founded upon certain fixed principles. It is clear, for example, that at any time—taking two extreme cases—the yield on British Government Securities will always be considerably less than that obtaining on a silver mine situated in Mexico. No expert knowledge of investments is necessary to indicate the overwhelming superiority of the quality of the former over the latter. What, then, are the determinants of yield? In other words, what determines the status of investments?

There are four points of importance which require stressing in order to answer this question satisfactorily. The first is that yields generally vary directly with ruling rates of interest; that is to say, that in times of cheap money—which predicate low rates of interest —yields will tend all round to be much less than in times of dear money—which predicate high rates of interest. The search for a yield more satisfactory than that obtaining in the case of, say, British Government Securities will tend to create a demand for

other investments, thus forcing up their prices and tending, therefore, to reduce the yield therefrom.

The second is that temporary and transient features often tend to obscure true values.

Many companies whose pre-war Standard for Excess Profits Tax was low, suffered severely through the incidence of this tax and with the abolition such companies benefit considerably.[1] Rumours favourable or adverse, periods of intense activity or extreme sluggishness, market manipulations; these and many more causes may, in a short term period, have the effect of creating a state of disequilibrium.

The third is that many investments are priced at a figure bearing no relationship to yield, either being gambling counters, or exceptional "bell wether" stocks (the well-known United States Steel Corporation is an excellent example of that type) or shares which offer alluring prospects for the future, although they may be making no profits or actually losing money, for example, gold mining companies and, more recently, companies with direct or indirect interests in Canadian oil.

The fourth is that certain shares may be priced purely on the prospects of a liquidation value, that is, on the basis of what they are likely to return by way of capital, the question of yield not entering into the question, except that if the process of liquidation is likely to be protracted, allowance must be made for the loss of dividend or interest the investor would otherwise receive.

The following are the chief factors affecting the yield required on ordinary shares—

(1) The estimated annual return, having regard to the nature of the business, and the risk involved. This return requirement will itself be influenced by general market conditions and ruling rates of interest. It is a significant fact that the investor will pay *more* attention to dividends than to earnings so that, *ceteris paribus* two similar companies may be paying the same dividends on greatly differing earnings, yet the prices of the shares of each company will tend to approximate to each other (unless influenced by other factors).

(2) The trend of profits having regard to the capital required in the business. The mere size of profits earned without taking into account the real capital employed affords no guide in determining yield.

(3) Stability of earnings: the company with stable earnings as compared with the company whose earnings are highly fluctuating will command a superior status, other things being equal. In this connection it is important to remember that the management factor —involving the question of ability and integrity—is vital. Particularly important is this factor in a small company as, to take one example only, unscrupulous directors might be able to alter the

[1] The gain is not wholly retained, as the released profit is subject to Income Tax at 9s. in the £ and Profits Tax.

articles of association so as to increase their remuneration and thereby bring down the amount of future profits. The latter point naturally leads to the next, namely,

(4) Voting rights of members and the degree of power possessed by the executive. For instance, the latter may own more than 50 per cent of the whole voting strength: even if less, it may effectively exert a decisive influence.

(5) The reliability of profit, and Balance Sheet disclosure. The current Balance Sheet should be capable of being linked up with the preceding one, and the profit disclosed reconciled therewith. The separation of abnormal from normal profits and losses, and the further classification of assets and liabilities, including provisions for taxation, etc., is important.

(6) The prospects of a company may be sufficiently bright to induce an investor to remain content with a small yield. The prospects may take the form of an early resumption of dividends, capitalization of reserves, or the possibility of the company requiring more capital and offering members the right of subscription on "bonus terms." It is true that, unless future earnings increase, the value of the shares will tend proportionately to decrease; for instance, if the share capital was doubled, there being double the quantity of "share claims" on earnings, the price of the shares would tend to fall to approximately half that obtaining before the further issue was made. Despite this, the advantages arising from this procedure are sometimes very great (particularly to persons liable to Sur-tax who would be able to sell the bonus shares and thus escape Sur-tax, although the shareholder could sell part of his holding from time to time even if no bonus shares were issued) and may in practice more than compensate for a comparatively small formal yield.[1]

Theoretically, if the company's profits do not rise by reason of the further issue, there will be a loss to the investor.

This may be illustrated simply as follows—

A company pays 10 per cent annually, the yield being 5 per cent. The price of a £1 share fully paid will therefore be—

$$\frac{10}{5} \times 20\text{s.} = \underline{\underline{£2}} \text{ x. d.}$$

The company decides to offer to its shareholders one share for two at £1. As the company now has in issue three shares for every two (before the issue), unless the earnings rise, the dividends in future will be $6\frac{2}{3}$ per cent only ($\frac{2}{3}$ of 10 per cent) and therefore the price will be—

$$\frac{6\frac{2}{3}}{5} \times 20\text{s.} = \underline{\underline{£1 \text{ 6s. 8d.}}} \text{ x. d.}$$

Therefore, the shareholder, assuming he took up the shares

[1] Many companies are now utilizing part of their reserves by issuing *Preference* Shares instead of ordinaries, thus giving the Ordinary Shareholders such benefits as are possessed by the Preference Shares as to dividends and capital.

offered, will lose. This is clearly discernible by assuming that A has 100 shares in the above imaginary company. Before the issue the value of his holding is—

$$100 \times £2 = \underline{\underline{£200}} \text{ x. d.}$$

When he has taken up his further shares, namely, 50 at £1, he has 150 shares worth £1 6s. 8d. each, equals £200. Thus, despite having paid in to the company £50, he is receiving no more in the aggregate by way of dividends than he did prior to the issue, so that he incurs a loss on the transaction. But in practice it does not work out like that, because, given normal circumstances, it will generally be assumed that a company will be able to utilize profitably its extra capital. If, therefore, in future, the above company will be still able to maintain its 10 per cent rate, the value of the new shares will be £2, thus making the value of 150 shares £300. Hence the benefit attaching to the original 100 shares held before the further issue is £50. This can be seen as follows—

	£
100 Shares at £2	200
Add Cost of 50 Shares at £1 . . .	50
	250
Profit	50
150 Shares at £2	£300

There is thus a profit of £50 in terms of the original 100 shares; and the "rights" are worth £1 per new share.

(7) The financial position of the company will also influence yield, in that the investor must consider such questions as reserves, liquidity of capital, quantity of goodwill, wastage of assets, etc.

(8) Technical market factors, for example, whether a share is cum div. or ex div., rates of exchange as affecting price of foreign shares, flight of capital, quantum of shares held, etc.

(9) The latter point may be illustrated by reference to *Short and another* v. *Treasury Commissioners* where the question of the valuation of shares taken over by the Government was the subject of arbitration, the Treasury's valuation being 29s. 3d. and the Arbitrator's 41s. 9d. The former was taken as being the fair price as it was that quoted on the Stock Exchange, the value being that, in the opinion of the Treasury, as between willing buyer and willing seller. The Stock Exchange price was considered by two shareholders as being a depressed price, whereas on a fair valuation the shares were considered to be worth 41s. 9d. (as per the Arbitrator's view based upon fair earning capacity). The shareholders maintained that Stock Exchange values did not appraise the correct position.

The court's decision was that whilst the Stock Exchange quotation was the best criterion normally, yet it was not conclusive and might be displaced by evidence affecting the value, the reasoning being—

"If an *individual* shareholder in a company owns such a number of shares in any company as gives him effective control of the company's affairs, it may well be that the value to be attributed to that holding upon a sale of it as a separate transaction is a figure greater than the sum arrived at by multiplying the number of his shares by the market value for the time being of a single share. In such a case a shareholder in question has got, and is able to sell, something more than a mere parcel of shares."

The two claimants, the court held, had not such a holding as confers an effective control of the company's affairs. In other words, the shares had no "control" value and the court dismissed the claim for the payment of 41s. 9d. per share.

(10) The nature of the capital structure, for example, the ratio of ordinary shares to preference shares. This ratio is of the greatest possible importance, as in a period of increasing prosperity a company with comparatively few ordinary shares in relation to preference shares will be able to step up the dividends on its ordinaries in a very marked degree, and therefore such shares would tend to increase enormously in value under these circumstances.

(11) The effect of death or sale of shares by any member with large and influential holding, particularly as regards continuity of management and contacts.

(12) The fact that in non-quoted shares no free market exists.

(13) General economic conditions.

(14) Inauguration of Sinking Fund for redeeming redeemable preference shares, or continuing acquisitions of fixed assets secured by borrowing on Mortgage Debentures, necessitating increasing use of profits to build up Debenture Redemption Fund.

(15) Political, financial and other external factors.

Where a valuation of ordinary shares is required in the case of the death of a member of a private company, if the deceased held a controlling interest therein within five years of his or her death, such valuation would follow the somewhat involved procedure laid down by Sect. 55, Finance Act, 1940.[1] The valuation would be made, not by reference to dividends, but total assets, otherwise the basis would be (following the general principles already discussed)—

(1) The amount and stability of profits (averaged over a reasonably indicative period) adjusted to give effect to matters known or likely to affect future profits.

(2) Dividends.

(3) Reserve appropriations.

(4) Capital—both as to amount and structure.

[1] Sect. 55, Finance Act, 1940, does not apply if the shares were actually dealt in on any recognized Stock Exchange within twelve months before the date of death.

Sect. 47, Finance Act, 1946, amended the original period of three years to five years.

(5) Risk involved. Normal yield expected from shares of companies of a similar nature would be deducible from the shares of such companies quoted or dealt in on the Stock Exchange.

(6) The utilization of the formula—

$$\frac{\text{dividends}}{\text{yield}} \qquad \begin{array}{l}\text{par (or paid up)}\\ \text{amount of share.}\end{array}$$

Obviously, even if the deceased had not a controlling interest, the effects (if any) of the death would require consideration. Normally the effect would be negligible unless the holding, without necessarily being controlling, were substantial.

Equity or "Net Assets" Basis. The procedure of arriving at the value of a share employed in the equity method is simply to estimate what the assets, less liabilities, are worth, i.e. the "net" assets—allowing for a probable loss or possible profit on book values—the balance being available for shareholders. Included in the liabilities may be debentures, debenture interest, expenses outstanding, and possibly preference dividends if the articles of association stipulate for payment of "arrears" in a winding up.

If there is one class of share, say ordinary share capital, or even preference and ordinary share capital where the holders of the former have no priority as to capital, the balance available over the total number of shares will represent the value of such shares.

Illustration.

BALANCE SHEET

	£		£
Share Capital—		Sundry Assets . . .	51,000
10,000 6% Preference Shares of £1 each fully paid .	10,000	Discount on Debentures .	1,000
30,000 Ordinary Shares of £1 each fully paid . .	30,000	Preliminary Expenses . .	3,000
		Profit and Loss Account .	6,000
	40,000		
General Reserve . . .	2,000		
Debenture Redemption Fund	3,000		
7% Debentures . . .	5,000		
Depreciation Fund . .	1,000		
Sundry Creditors. . .	10,000		
£	61,000	£	61,000

It may be assumed that the assets are worth their book value, that debenture interest for one year is owing, and that the dividends on the preference shares are two years in "arrear." Show the approximate valuation of the shares, ignoring tax.

Solution. Find the "net" assets, and in so doing care must be exercised in dealing with reserves. The debenture redemption fund is not a liability, but a portion of the undistributed profits (or in this case a deduction from the loss) and exists as such in accordance with the terms of the debenture deed.

Although it is of no moment here, the student should be familiar with the two alternative methods of arriving at "net" assets—

		£	£
(a)	Assets		51,000
	Less Liabilities—7% Debentures	5,000	
	Depreciation Fund	1,000	
	Sundry Creditors	10,000	16,000
			35,000
	Less Debenture Interest owing		350
	"Net" Assets		£34,650
(b)	Share Capital	40,000	
	Reserve	2,000	
	Debenture Redemption Fund	3,000	
			45,000
	Less Profit and Loss Account	6,000	
	,, Discount on Debentures	1,000	
	,, Preliminary Expenses	3,000	
			10,000
			35,000
	Less Debenture Interest owing		350
	"Net" Assets		£34,650

If the preference shares are preferential as to capital they have the first "charge" on the assets, and as there are ample assets, they are fully covered. In the absence of further participation rights, they are worth £1 each.

The "net" assets available for the ordinary shares are—

	£
Balance as above	34,650
Less Preference Shares	10,000
"Net" Assets	£24,650

Hence, the ordinary shares are worth $£\frac{24,650}{30,000}$ = 16s. 5d. to the nearest penny.

Should the preference shares be on the same basis as the ordinary shares for capital repayment purposes (merely having the right to dividends only in priority to the ordinary shares) then the value of all the shares = $£\frac{34,650}{40,000}$ = 17s. 4d. to the nearest penny.

If the "*arrears*" *of dividends* are to be repaid to the preference shareholders in a winding-up as well as capital in priority, then the valuations will appear as under—

	£
"Net" Assets	34,650

Of which the preference shareholders will take—

	£	
Capital	10,000	
Plus Preference Dividends (2 years at 6% per annum on £10,000, ignoring Income Tax)	1,200	
		11,200
Balance to Ordinary Shareholders		£23,450

The preference shares, cum div., are therefore worth $£\frac{11,200}{10,000} =$ £1 2s. 5d. each, and the ordinary shares are worth $£\frac{23,450}{30,000}$ = 15s. 7d. each.

Lastly, if the "arrears" of dividends are payable as in the preceding example, but WITHOUT priority as to capital, the result will be as follows—

	£
"Net" Assets	34,650
Less Preference Dividend	1,200
	£33,450

The value of all the shares will be $£\frac{33,450}{40,000}$ = 16s. 9d., to which will be added $£\frac{1,200}{10,000}$ per share for dividend for preference shareholders = 2s. 5d.

Hence, preference shares are worth 16s. 9d. + 2s. 5d.= 19s. 2d.

Ordinary shares are worth 16s. 9d.

Even if the equity basis were adopted, there would be many subsidiary matters calling for consideration, e.g. the ratio of fixed and floating assets and their valuation; the proportion of assets acquired at a period of high inflation; the rate of profits earned and the consistency thereof; the rate of development of the business; the trend of profits IN RELATION TO CAPITAL REQUIREMENTS; the effect of events between the last Balance Sheet and the date of the required valuation. Further, in case of death or transfer, it should always be the subject of inquiry as to the effect, if any, upon the prospects and earning capacity, of the substitution of the new holder for the old, as even in large companies the personnel of the directorate counts very considerably.

It need hardly be stressed that when a company is (*a*) known to be at the end of its life, or (*b*) likely to be taken over on an asset basis by another company, the valuation will be on the above-mentioned basis, even if quoted on the Stock Exchange, because the market value will naturally be based on the break-up basis.

Illustration. Using the "income" basis in the illustration on page 1158, and assuming that 25 per cent dividend is payable, find the probable approximate value which could be placed on the ordinary shares.

It will be seen that no visible reserves exist, but there may be secret or undisclosed reserves; if none exist it would appear that dividends have been distributed fully in the past. This, together with the result for the current year (unless accounted for by special circumstances) may tend to require a slightly higher risk than would otherwise be the case. It is assumed that 8 per cent represents a fair return on the class of share in question.

The valuation of the ordinary shares is $£\frac{25}{8}$ = £3 2s. 6d. If the dividend has been declared (or the market is reasonably certain

that it will be declared shortly) the price will be £3 2s. 6d + 5s.[1] = £3 7s. 6d.

Assuming that 8 per cent is a fair return, the purchaser of 1,000 of these shares cum div. would pay—

	£
1,000 at £3 7s. 6d.	3,375
Less Dividend receivable	250
Net Cost	£3,125

His yearly dividend (assuming no change of circumstances) will be £250, i.e. 1,000 at 5s., hence he receives an annual return of £250 for his net outlay of £3,125 which is exactly 8 per cent.

General Illustration. Two companies, A and B, are assumed to be exactly on the same footing, not only as to assets, liabilities, and reserves, but also as to all other factors except that the arrangement of the share capital differs.

The share capital of each company is £10,500 in fully paid shares of £1 each, constituted as follows—

A	£	B	£
10,000 6% Preference Shares . .	10,000	1,000 6% Preference Shares . .	1,000
500 Ordinary Shares . . .	500	9,500 Ordinary Shares . . .	9,500

The ordinary shares of the companies may be taken to represent a somewhat speculative industrial risk and the market yield is 8 per cent.

The companies' profits and distributions are: 1951, £1,960; and 1952, £630.

Estimate the approximate probable prices of the ordinary shares of the companies, ignoring all facts other than those stated above.

The approximate probable prices are—

	A		B	
	1951 £	1952 £	1951 £	1952 £
Profits	1,960	630	1,960	630
Less 6% Preference Dividend .	600	600	60	60
Available for Ordinary Shares . .	£1,360	£30	£1,900	£570
Dividends	272%	6%	20%	6%
Price [x d]	£$\frac{272}{8}$ = £34	£$\frac{6}{8}$ = 15s	£$\frac{20}{8}$ = £2 10s	£$\frac{6}{8}$ = 15s.

It will be seen that, although the profits are the same in both companies, the fluctuations in the prices of the ordinary shares are great. The company having the smaller proportion of ordinary or equity shares is A, and such shares will stand very high in

[1] 25 per cent of £1 = 5s., ignoring tax.

relation to the ordinary OR equity shares of the other company in a PROSPEROUS period and fall very steeply in a SLUMP period. Hence the "high geared" equity shares (i.e. low in proportion to the preference shares) will rise rapidly in a period of prosperity and fall rapidly in a period of depression, as in (A), whilst "low geared" equity shares (i.e. high in proportion to the preference shares) will rise more slowly in a period of prosperity, and suffer a more gradual fall in a period of depression, as in (B).

Valuation of Preference Shares. The holder of preference shares seeks security as to capital (and with that in view he will be anxious to see that if a winding up ever arises the preference shares have priority over ordinary shares); and secondly, security as to dividends, and from this angle the purchaser will be very much concerned with the rate of dividend payable as well as the question of whether the shares are cumulative or non-cumulative. The preference share is of a precarious nature as will be gathered from the following reasons—

(1) They may be non-cumulative.

(2) Even where they are cumulative, the preference shareholder is not *guaranteed* an assured annual return on his share. For that matter, nor is a debenture-holder, but the latter's interest does constitute a *charge* upon the profits, and is not merely an *appropriation* of them.

(3) The amount represented by the yearly dividend is a *maximum* return.

(4) Even if the company has ample earnings, the valuation will be largely affected by ruling rates of interest. For instance, a purchaser of preference shares may be prepared to pay 30s. for a £1 6 per cent preference share. Such a share will bring the holder, in ordinary circumstances, a return of 4 per cent per annum, but should rates of interest become harder, a preference share of the type that formerly yielded 4 per cent might be required to yield, say, 6 per cent, thus involving a decline in the share value to £1 or so. This possibility of a decline is not as remote as might appear at first sight, even in the highest grade companies, as recent events have shown. There is also the danger that preference shares purchased at a big premium might be repaid by the company to the holder at par—or even less—by reason of the company being wound up, and although, it should be observed, the Coal Nationalization Act sought to preserve the value of the preference shares of collieries by using the yardstick of dividends and not liquidation, stock exchange or repayment value, yet it has been judicially decided that the Directors may (and, indeed, ought to) pay off surplus Preference Capital, whether liquidation is contemplated or not (*re Wilson's and Clyde Coal Co.*, and *re Chatterley-Whitfield Collieries, Ltd.*).

Illustration. The following are the Balance Sheets of two well-established companies—

Balance Sheets

	H, Ltd.	S, Ltd.		H, Ltd.	S, Ltd.
	£	£		£	£
Issued Capital (all £1 fully paid)—			Freehold and Leasehold Properties at Cost, *less* Depreciation	67,200	14,755
50,000 5½% Preference Shares	50,000		Plant and Machinery at Cost, *less* Depreciation	12,300	3,711
100,000 Ordinary Shares	100,000		Fixtures, Furniture, and Fittings at Cost, *less* Depreciation	3,400	1,730
30,000 Ordinary Shares		30,000	Patents at Cost	8,000	
Profit and Loss Account	27,183	3,280	Debtors	5,200	7,388
Creditors	23,000	8,250	Stock	54,358	11,210
			Bank	19,725	2,736
			Shares in S, Ltd., at Cost	30,000	
	£200,183	£41,530		£200,183	£41,530

The preference shares are cumulative, non-participating, with priority as to repayment in a winding up. The capitals have remained unchanged throughout the history of the companies and ample depreciation has been written off assets, including leaseholds.

S, Ltd. is a subsidiary company of H, Ltd., which owns the *whole* of the Share Capital.

The profits (excluding dividends received by H, Ltd. from its holding in S, Ltd.) were—

	H, Ltd.	*S, Ltd*
	£	£
1946	14,200	3,700
1947	12,700	4,200
1948	18,100	1,800
1949	11,000	1,400
1950	26,000	3,700
1951	23,000	5,600
1952	28,000	6,900
	£133,000	£27,300
	Average = £19,000	Average = £3,900

A similar company's ordinary shares quoted on the Stock Exchange are round about par, its latest dividend being 6 per cent. The same company's 6 per cent preference shares are quoted at £1 4s. (This company may be assumed to be fairly comparable with H, Ltd. and S, Ltd.)

You are asked in 1953 to give your view as to the fair value of the shares of H, Ltd. and S, Ltd., as the directors contemplate receiving an offer for the purchase of such shares from a rival company. [Ignore Tax and the effect of E.P.L. on profits.]

The preference shares will be dealt with first.

The combined average profits for the seven years are sufficient to pay the preference dividend over eight times, and in the *worst* year, namely, 1949, the profits covered the preference dividends over four times.

The preference capital is covered by the combined net assets of the companies more than three and a half times. The net liquid assets of the companies are more than sufficient to cover the preference capital.

As the yield on a preference share of this type appears to be about 5 per cent, the approximate value of the preference shares is—

$$\frac{5\frac{1}{2}}{5} \times £1 = \underline{\underline{£1\ 2s.}}\ \text{ex div.}$$

As to the ordinary shares—

The combined average annual profits available for the ordinary shareholders are—

	£
Holding Company	19,000
Less Preference Dividend	2,750
	16,250
Subsidiary Company	3,900
	20,150
of which, say, 40%[1] is a fair allocation to Reserve, say	8,150
Available for Dividend on Ordinary Shares of 12%	£12,000

As normally the expected yield on ordinary shares of a similar company is 6 per cent, the valuation of the ordinary shares of the company under inquiry is—

$$\frac{12}{6} \times £1 = \underline{\underline{£2}}\ \text{a share, ex div.}$$

The following procedure will be a further test of the valuation—

The capitalized value of the ordinary shares is—

$$\frac{100}{6} \times £12{,}000 = \underline{\underline{£200{,}000}}$$

$$= \underline{\underline{£2}}\ \text{a share, ex div.}$$

The net tangible assets of the company are—

	£	£
Holding Company	170,183	
Less Creditors	23,000	
		147,183
Subsidiary Company	41,530	
Less Creditors	8,250	
		33,280
		£180,463

[1] A company is expected to allocate a substantial proportion of its profits to reserve nowadays. In practice, the amount would be affected by the charge for taxation.

	£
Valuation of Preference Shares—	
50,000 × £1 2s..	55,000
Valuation of Ordinary Shares—	
100,000 × £2	200,000
	255,000
Net tangible Assets	180,463
Excess, being estimated Goodwill	£74,537

The number of years' purchase of average profits of the two companies is—

$$\frac{74{,}537}{22{,}900} = \text{say } \underline{3{\cdot}25 \text{ years.}}$$

From the dividend aspect, the stability of dividend cover is the vital criterion. Such cover must be measured by reference, not only to an average, but to the company's most disastrous year. This is so, even if the preference shares are cumulative, and the more so if non-cumulative. The sole point of difference between them is that, in the case of the former, they will be entitled to receive the "arrears" before the ordinary shares are restored to the dividend list. The preference shareholder can only rely upon the results in any *one* year, because a surplus of a year's trading is generally available for the ordinary shareholders, and it is no answer that prudent directors will (or should) set aside a portion of a year's earnings to reserve.

In short, neither the normal nor abnormal years form the true guide, but the subnormal years. Violent fluctuations, though tending to maintain average, make it thoroughly unreliable as a measuring rod for stability.

Illustration. Steadfast, Ltd., and Erratic, Ltd., are two companies, each having a 6 per cent Preference Share Capital of £50,000 in fully-paid £1 shares. [Thus the preference dividend required is £3,000 per annum.] The following table shows the earnings and cover for the last six years.

	Steadfast, Ltd.			Erratic, Ltd.		
Year	Net Earnings	Times Covered	Deviation from Average	Net Earnings	Times Covered	Deviation from Average
	£			£		
1947	+ 15,000	5·00	·00	+ 93,000	31·00	26·00
1948	+ 14,100	4·70	·30	+ 24,000	8·00	3·00
1949	+ 16,500	5·50	·50	− *4,500*	− *1·50*	6·50
1950	+ 14,250	4·75	·25	− *27,000*	− *9·00*	14·00
1951	+ 15,750	5·25	·25	− *10,500*	− *3·50*	8·50
1952	+ 14,400	4·80	·20	+ 15,000	5·00	·00
	£90,000	(*b*) 30·00	(*a*) 1·50	£90,000	(*b*) 30·00	(*a*) 58·00

	Steadfast	Erratic
Average annual deviation $\left[\frac{a}{6}\right]$	(*c*) ·25	(*c*) 9·67
Average cover $\left[\frac{b}{6}\right]$	(*d*) 5·00	(*d*) 5·00
Coefficient of dispersion $\left[\frac{c}{d}\right]$	·05	1·93

It will be seen that the coefficient of dispersion in Steadfast, Ltd., is comparatively very small, and signifies a far greater degree of uniformity and stability than is the case of Erratic, Ltd.

The degree of stability of dividends will indicate the measure of risk attached to a preference share; and subject thereto, its value will tend to be in inverse ratio to the ruling rate of interest. For example, a 6 per cent £1 fully-paid preference share, adequately covered, may be priced to yield, say, 4 per cent. The price may, therefore, be expected to be around 30s. = ($\frac{6}{4}$ × 20s.) but as interest rates increase, so will the required yield, and hence the price will decrease in ratio. As with ordinary shares, the preference share yield will be greater in the case of a speculative company than in the case of a sounder concern; but so far as the preference share is concerned, not only the nature of the company's activities, but also the degree of stability must be taken into account.

In interpreting the coefficient of dispersion, it is necessary to inquire into special factors, e.g. differing stages of development, whilst the longer the period employed for comparison, the more reliable, in the absence of special factors, will be the deduction.

When dealing with cover, it is essential to bear in mind that the amount required to pay the dividend on prior preference shares must be deducted from the net earnings in gauging the cover for the junior preference shares; whilst the "gearing" principle (as shown on page 1161) is applicable.

Illustration. A company has three classes of preference shares—1st, 2nd, and 3rd—requiring a yearly dividend of £1,000, £3,000, and £1,500 respectively. Assuming the company's yearly profit to be £6,000, show the cover of each class of preference share.

Share	Balance of Profits	Required for Dividend	Times Covered	*Balance*
	£	£		£
1st Preference . . .	6,000	1,000	6	(*a*) *5,000*
2nd Preference . . .	(*a*) *5,000*	3,000	1⅔	(*b*) *2,000*
3rd Preference . . .	(*b*) *2,000*	1,500	1⅓	(*c*) *500*
Available for Ordinary Shareholders	(*c*) *500*			

Finally, even where the preference dividend is amply covered, as to both earnings and stability, the preference shareholder is usually precluded by the Articles of the company from receiving more than the nominal value of the share in a winding up; so that, theoretically at all events, a preference shareholder may lose the premium paid for the share in the event of the liquidation of the company.

Sale of Bonus Shares. There will be no profit on the sale of bonus shares until the holder has received therefor an amount

exceeding the proportion of the original net cost as represented by the subjoined formula—

$$\frac{\text{Bonus shares}}{\text{Old shares} + \text{bonus shares}} \times \text{Net cost of old shares.}$$

Illustration. A purchased 18,000 shares at £2 5s. each cum dividend, and received (1) a cash dividend of 7s. a share and (2) a bonus share dividend of "one for three." Write up the Ledger Account relating to the treatment of the bonus shares, assuming that they were sold at £1 8s. 6d. a share. Ignore tax and expenses.

Dr. SHARES IN ...., LTD. *Cr.*

		Nominal	Price	£			Nominal	Price	£
			s. d.					s. d.	
To Purchase .		18,000	[1]38 0	34,200	By Sale .		6,000	28 6	8,550
,, Bonus Share Dividend		6,000			,, Balance.	c/d	18,000	28 6	25,650
		24,000		£34,200			24,000		£34,200
To Balance .	b/d	18,000	28 6	25,650					

The amount of £8,550 is—

$$\frac{\text{Bonus shares (6,000)}}{\text{Old shares (18,000)} + \text{bonus shares (6,000)}} \times £34{,}200$$

$$\text{i.e. } \tfrac{1}{4} \times £34{,}200 \qquad = £\ 8{,}550$$

As the sale price of three-quarters of the original cost price of the shares [viz. $\frac{3}{4}$ × 38s.] is 28s. 6d., the investor has neither profit nor loss, for he has his original number of shares worth £25,650 and cash £8,550, amounting to £34,200, being the net cost of his original holding.

Sale of Bonus Rights. Where a company increases its issued share capital, giving the shareholders the right to apply for the new shares in a fixed proportion, many shareholders do not wish to increase their holdings and prefer to sell the "rights" for cash.

The approximate value of such "rights" is arrived at as follows—

(*a*) Add to the market price of the old shares the cost of the new shares.

(*b*) Divide the result obtained in (*a*) by the **total** number of shares now held.

(*c*) Deduct the result obtained in (*b*) from the market or cum bonus quotations, giving the approximate value of the "right."

Illustration. A company whose shares stand at 28s. cum bonus offers shareholders the right to apply for two new shares at 21s. each for every five held. Show the approximate value of the "right."

[1] Cost 45s., less dividend 7s.

			s.
(a) Old shareholding	5 × 28s.	=	140
New shareholding	2 × 21s.	=	42
	7		182
(b) 182s. divided by 7			26
(c) Market value 28s., less 26s. is the approximate value of the "right"			2

Alternatively, the calculation is as follows—

$$\frac{\text{New shares}}{\text{Total shares}} \times \text{(cum bonus price minus new issue price to shareholders)}$$

i.e. $\frac{2}{7} \times (28s. - 21s.) = 2s.$

Published Accounts. Study of published accounts of limited companies shows that the degree of disclosure of the less enlightened is that dictated by legal compulsions; and there is a marked reluctance to discard the reticent attitude of former years.

With the moral persuasion of the Institute of Chartered Accountants and the Society of Incorporated Accountants and the further legal requirements of the Companies Act, 1948, much progress has been made to give the shareholders much fuller and better arranged information concerning the results of companies' operations and financial state.

The chief omissions are (or have been)—

(1) Obscurity of remuneration of directors, particularly where arising from Subsidiaries of a Holding Company.

(2) Failure to give profit figures before taxation.

(3) Even where profit is given before taxation, failure to differentiate between the types of tax, or disclose the basis of the tax charge.

(4) Failure to show provisions for depreciation and/or diminution of assets.

(5) Inclusion of undistributed reserves amongst creditors.

(6) Failure to show in the accounts of Holding Companies the *amounts* of dividends received from Subsidiary Companies.

(7) Inclusion of Stock without stating the basis of valuation.

General Observations on Asset Values. Where assets carry income or appreciate in value by effluxion of time, there will generally be a short term equilibrium based on demand and supply within the bounds marked out by the marginal seller and buyer, the main factors being the assured continuity of the asset and ruling rates of interest. as expressed in the present worth, being the discounted price of the future earnings, whether identifiable periodically (e.g. annually) or being identified in the increment of value at the end of the stipulated period. Strictly in the latter, the present worth is that sum of money now laid out, together with any interim payments, which will accumulate at a given rate per cent to a specific sum. Where the earnings are identifiable, regard will have to be taken of any loss in value at a future date, e.g. a fixed interest

security now standing at a premium of 4 per cent (£104 for £100 Stock), but liable to be repaid at par at a fixed future date.

Illustration.

Asset	Basis of Valuation
Reversionary Interest . . .	Present worth of amount at which it will fall into possession [i.e. death of life tenant], based on expectation of life.
Life Policy	Present worth of the amount payable at maturity, having regard to annual premiums payable and expectation of life assured—the risk involved being greater than a policy falling in at a fixed date [e.g. Amortization Policy].
Ground Rents	Number of years' purchase of the annual sum payable, e.g. if the ruling rate was 4 per cent, the number of years would be $\frac{100}{4}$ = 25 years.

Where there is not a stable earnings factor, the emphasis on *future* earnings[1] is more marked and generally much more difficult, the past results often being of little consequence, e.g.—

(*a*) In the valuation of shares, the imposition of E.P.L. and the incidence of Profits Tax (and any change thereof) may alter materially the amount of distributable profits (see page 1170).

(*b*) Patents in respect of, say, Steam Locomotives might carry much less value than for Diesel Locomotives.

(*c*) A copyright on a book on War Damage Contributions or E.P.T. or the Companies Act, 1929, would be worthless eventually.

Various methods have been taken in recent nationalization compensations, e.g. giving of securities with equal yields, or based on Stock Exchange values, or giving securities of the same *nominal* value as the compensation value.

The gearing of the preference and ordinary shares is important in ascertaining the effects of the Profits Tax.

Illustration. For the year to 31st December, 1953, two companies each had profits of £10,000 before taxation. Their capitals were—

	A	B
	£	£
Issued Share Capital (all £1 fully paid)—		
4% Preference	50,000	—
6% Preference	—	100,000
Ordinary	150,000	100,000
	£200,000	£200,000

[1] In any case, although investors pay due regard to the present and future *earnings* position, they are influenced more by the present and future *dividend* position, so that where two companies have similar capitalization and dividend rates, they will be likely to command a similar price, although the earnings of one of these companies may exceed greatly that of the other.

Assuming that the whole profit (after providing for taxation) is distributed, show the decrease in ordinary dividend as a result of the incidence of Profits Tax of 22½ per cent (with relief of 20 per cent for undistributed profit). No adjustments are required to the profit for the purpose of the tax computations. Take Income Tax at 9s. in the £. There is no liability to E.P.L.

	Without Profits Tax		With Profits Tax		*Without Profits Tax*		With Profits Tax	
	£	£	£	£	£	£	£	£
Trading Profit		10,000		10,000		10,000		10,000
***Less* Profits Tax**				1,650				1,650
				8,350				8,350
Income Tax		4,500		4,500		4,500		4,500
Available for Dividends		£5,500		£3,850		£5,500		£3,850
Preference Dividend	2,000		2,000		6,000		6,000	
***Less* Income Tax**	900	1,100	900	1,100	2,700	3,300	2,700	3,300
Ordinary Dividend	8,000		5,000		4,000		1,000	
***Less* Income Tax**	3,600	4,400	2,250	2,750	1,800	2,200	450	550
		£5,500		£3,850		£5,500		£3,850

The Income Tax liability remains at 9s. in the £ on £10,000 in each case and, since Profits Tax is no longer a charge against profits for income tax purposes, cannot be recouped out of the dividends payable to the shareholders. The Income Tax liability normally arises in the following year, but the usual procedure is to provide against the current profit the Income Tax liability thereon, notwithstanding that the "legal" liability will not arise until the following year.

The Profits Tax liability of £1,650 is 2½ per cent of £10,000 plus 20 per cent of £7,000, or 22½ per cent of the total profit of £10,000 less relief for non-distributed profit of 2½ per cent of £3,000.

The reductions as a result of the incidence of Profits Tax are—

	A	*Share Value on a 5% Basis*	B	*Share Value on a 5% Basis*
		s. d.		*s. d.*
Ordinary Dividend (*without Profits Tax*)	£8,000 = 5·33%	21 4	£4,000 = 4%	16 0
Ordinary Dividend (with Profits Tax)	£5,000 = 3·33%	13 4	£1,000 = 1%	4 0
Percentage reduction	$\frac{8s.}{21s.\ 4d.} \times 100$	37.5%	$\frac{12s.}{16s.} \times 100$	75%

The decrease in gross ordinary dividend is equal to the amount of profits tax grossed up at 9s., i.e. $\frac{20}{11} \times £1{,}650 = £3{,}000$.

From the gross profits of £10,000 there must first be deducted

income tax at 9s. and profits tax at $2\frac{1}{2}$ per cent, leaving $52\frac{1}{2}$ per cent of the profits, or £5,250, available for net dividends and additional profits tax thereon at 20 per cent of the gross amount. The amount available for net dividends (D) may be found by the following formula—

$$D + \left(20\% \text{ of } \frac{20}{11} D\right) = £5,250$$

$$D + \frac{4}{11} D = £5,250$$

$$D = \underline{\underline{£3,850}}$$

Statistical Cards. In connection with the question of profits earned and retained, it is the invariable practice to show on the statistical cards (published by firms specializing in this class of work) the average of priority of each class of shareholder, so that at a glance it can be seen whether the dividend is well protected or is marginal.

Some cards modify this procedure by taking the profit *before* providing for interest on prior charges and show the information as in the preceding paragraph, except that the prior charges are shown as a disposition of the profit.

The procedure is to take the profit as a unit of 100 and reduce the prior charges (where the method is adopted as shown in the preceding paragraph), dividends on each class of share, allocation to reserve, and balance forward as part of such unit of 100 of profit, showing how much thereof is used for the respective items.

Illustration. A company (before providing for its Debenture Interest) earns for the year £20,000, and pays Debenture Interest, £3,000; Preference Dividend, £6,000; Ordinary Dividend, £5,000; allocation to Reserve, £4,000; and increase of carry forward by £2,000.

Show the disposition in terms of percentage of profit.

Debenture Interest	*Preference Dividend*	*Ordinary Dividend*	*Reserve*	*Carry Forward*
%	%	%	%	%
0–15	16–45	46–70	71–90	91–100

CHAPTER XXVIII

ASSURANCE ACCOUNTS

Introduction. The business of an insurance company consists of carrying risks on behalf of its clients in consideration of monetary reward. The risks which can be insured against are innumerable, but, in so far as concerns the student of accountancy, the chief forms of insurance are life, fire and marine risks, and loss of profits.

In the main, the principles of ordinary book-keeping apply to insurance accounts, the premiums received being the equivalent of sales and the claims the equivalent of purchases.

There are a few peculiar features concerned with *life* insurance (or assurance, as it is more frequently termed). The law provides that at least every five years a valuation must be made by an actuary, the prime purpose of which is to ascertain the liability in respect of UNMATURED risks. The life assurance company (over the five years) treats the excess of premiums received over claims and expenses as potential profit. Before this balance can be considered as final profit, it is essential to take into account the estimated liability in respect of policies in being (as well as of annuities, which will be dealt with later), the balance only being treated as distributable profit.

There are several terms employed in life assurance accounts which it is necessary to comprehend thoroughly before the entries relating to them can be recorded in an intelligent manner.

(I) Premiums and Claims, Consideration for Annuities Granted, and Annuities. In order to appreciate the meaning of these expressions the fact must be grasped that the two principal functions of a life office are converse in their operation.

(*a*) **Life Policies**—

In the first place, a company may agree to pay a LUMP sum in the event of death, or other contingencies, or after the expiration of a number of years. In the meantime the client pays a sum of money EACH year (or other agreed period) and, other things being equal, the older the person effecting this kind of insurance, the higher the premiums (i.e. periodic payments) owing to shorter expectation of life. (Actually, the sex of the client is also important, the expectation of life of a female being slightly higher than that of a male.)

(*b*) **Annuities**—

In the second place, a client, having no dependants for whom he wishes to provide, may desire to secure a FIXED INCOME each year, and is prepared to sacrifice his capital in order to enjoy this security. It may be mentioned here that such yearly payment, which is described as an annuity, is greater than the return obtained from

the same capital invested in gilt-edged stock. The process is the reverse to that of issuing a policy. Under a *policy* the company receives PERIODIC payments in return for an agreement to pay a LUMP sum at the later date; whilst under an arrangement for an *annuity* the company receives a LUMP sum at once in consideration for PERIODIC payments so long as the annuitant may live, or otherwise, as may be arranged.

The term "Consideration for Annuities Granted" refers to the receipt of the lump sum; and the "annuity" to the annual or periodic return to the client.

The entries in Journal form will be, respectively—

(1) On receipt of the "Consideration for Annuities Granted."

JOURNAL

			£	£
	Cash . . . . . . *Dr.* (say)		1,500	
	To Consideration for Annuities Granted			1,500

(2) On payment of the Annuity.

JOURNAL

			£	£
	Annuity Account . . . *Dr.* (say)		80	
	To Cash			44
	,, Income Tax (at 9s.) . . .			36

The consideration for an annuity granted is analogous to a "Sale" and the annuity payment to a "Purchase."

Obviously the actuarial liability for annuities will have to be computed, as it is clear that the £1,500 cannot be taken immediately to Profit and Loss Account, but the OLDER the annuitant, the LESS the actuarial liability.

Pursuing this point further it is seen that—

(1) the OLDER the person, the LOWER the cost of the annuity.

(2) the OLDER the person, the HIGHER the cost of the policy (i.e. yearly premiums).

The entries for policies are—

JOURNAL

			£	£
	Cash . . . . . . *Dr.* (say)		85	
	To Premiums Account . . .			85
	On receipt of the annual premium.			
	Claims Account . . . *Dr.* (say)		1,400	
	To Cash			1,400
	On payment of claim.			

When the annuitant or policy holder dies, the "Life" will be ignored in the quinquennial valuation, because the whole transaction is complete in the accounts and—

(1) The annuitant's lump sum (less annuities paid) is now all realized profit, and no further liability exists.

(2) The lump sum due under the life policy is now an **ascertained** liability.

As has been mentioned the actuarial valuation concerns itself not with ASCERTAINED liabilities but with those relating to UN-MATURED risks.

(II) **Reinsurance.** This term signifies an arrangement made between two insurance companies whereby one agrees to take over a portion of the risk incurred by the other in consideration for a proportion of the premiums received. By such arrangement, the company which originally effected the insurance reduces both its liability and its NET premium income.

(III) **Surrenders.** A policy holder has, after a period varying with different types of policies and different companies, the right to surrender or cancel his policy. Naturally he will suffer some loss, varying with the circumstances. The amount receivable for the unexpired policy is known as the "Surrender Value" of the policy. The entry in the insurance company's books is as follows—

JOURNAL

			£	£
	Surrenders Account . . . *Dr.* (say)		100	
	To Cash			100

In the accounts, this is shown as a "Purchase" item, but the unseen benefit will be reflected in the quinquennial valuation because there is now no risk against which to provide, as the policy is now cancelled. The other items of assets, liabilities, income, and expenditure call for no particular comment.

It will, however, be necessary for the student to keep the following facts clearly before his mind—

(1) Consideration for Annuities Granted. }
(2) Premiums. } Correspond to SALES;

(3) Annuities. }
(4) Claims. } Correspond to PURCHASES;
(5) Surrenders. }

whilst

(6) Reinsurance may be treated as a "SALES RETURN," i.e. deducted from Premiums Account. By statute, life assurance companies are required to present their published accounts in a prescribed form

which will be outlined later (see pages 1176 and 1181), but save for one or two particular features there is no important departure from the presentment of ordinary commercial accounts. The points that call for attention are—

(1) The published Accounts are in the form laid down by the Assurance Companies Act, 1909, and to a certain extent by the Companies Act, 1948, Eighth Schedule, Part III, paragraph 26 (see page 1047).

(2) The income and expenditure is recorded in form (*a*) Revenue Account (termed First Schedule); (*b*) Profit and Loss Account (termed Second Schedule). The latter approximates to a Profit and Loss *Appropriation* Account.

(3) The Revenue and Profit and Loss Accounts are in **reverse form**, i.e. the gains are upon the DEBIT side, the losses upon the CREDIT side. The detailed accounts in the books are on the normal sides.

(4) The accumulated surplus of premiums and consideration for annuities granted over claims, annuities, and expenses, i.e. the "Fund," is inserted in the Revenue Account on the debit side at the commencement of the year, and the "Fund" at the end of the year will be the balancing item on the credit side (being brought forward as a *debit* balance next year).

(5) Interest and dividends (being gains) are shown on the debit side of the Revenue Accounts, but they must be shown GROSS and the tax shown separately as a deduction therefrom.

(6) The Balance Sheet (Third Schedule) is drawn up on the usual lines, i.e. assets on the right hand and liabilities on the left hand.

(7) A special form is required for the Revenue Account according to the class of business transacted, viz.—

Form A—Life Assurance.
,, B—Fire Insurance.
,, C—Accident Insurance.
,, D—Employers' Liability Insurance.
,, E—Bond Investment.

It will be as well for the student to observe that in the published accounts the items, either gains or losses, assets or liabilities are always on the *opposite* side to that upon which they appear in the books themselves.

Before dealing with the detailed accounts the following statutory requirements should be noted—

(1) Where the company proposes to carry on life assurance a deposit with the Paymaster-General of the High Court of £20,000 must be made, which will be invested in approved securities.

(2) If it proposes to carry on other classes of insurance (fire and accident excepted) it must deposit a like sum for each distinct class of business.

(3) Any interest received upon the deposit belongs to the Revenue Account of the particular branch for which it was made.

(4) If the company carries on employers' liability insurance and/or bond investment business, as soon as the separate funds in each case amount to £40,000 the deposit is returnable, provided that the normal deposit is maintained for any other class of business.

(5) No transfer may be made from one fund to another.

Illustration. The balances of a Mutual[1] Life Assurance Co. appear in the books on 31st December, 19.., as follows—

Balances		*Dr.* (in £000's) £	*Cr.* (in £000's) £
Mortgages		1,500	
Ground Rents		145	
Loans		155	
Investments		1,200	
Surrenders		25	
Agents' Balances		5	
Deposit with High Court		20	
Outstanding Premiums		35	
Premiums			3,394
Claims by Death	£1,000		
,, Maturity	700		
		1,700	
Commission		14	
Consideration for Annuities Granted			420
Interest and Dividends			100
Annuities		12	
Fund			950
Bank		50	
Expenses of Management		3	
		£4,864	£4,864

You are required to prepare Final Accounts, ignoring 000's.

FIRST SCHEDULE

REVENUE ACCOUNT OF THE MUTUAL LIFE ASSURANCE CO.

for the year ended 31st December, 19.., in respect of Life Assurance Business

Dr.		£			*Cr.* £
Amount of Life Fund		950	Claims by Death	£1,000	
Premiums		3,394	,, ,, Maturity	700	
Consideration for Annuities Granted		420			1,700
Interest and Dividends	£?		Surrenders		25
Less Income Tax	?		Annuities		12
	—	100	Commission		14
			Expenses of Management		3
			Amount of Life Fund		3,110
		£4,864			£4,864

[1] No share capital exists as contrasted with a proprietary company.

THIRD SCHEDULE

BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£			£
Life Assurance Fund	3,110	Mortgages		1,500
		Loans		155
		Investments—		
		Deposit with High Court	£20	
		British Government and other Funds [in specified order]	1,200	
		Ground Rents	145	
				1,365
		Agents' Balances		5
		Outstanding Premiums		35
		Bank		50
	£3,110			£3,110

The Second Schedule (i.e. Profit and Loss) will simply consist of the balance of revenue (i.e. First Schedule) as there are no appropriations or other profits in this illustration.

In the foregoing illustration it will be noted that there was an accrual item, "Outstanding Premiums." This would have been created by the following entry—

Outstanding Premiums Account	*Dr.*	= Asset
To Premiums Account	[1]	= Revenue Gain

In addition to the above a similar entry would be required where interest and dividends are outstanding, i.e.—

Interest and Dividends Outstanding Account	*Dr.*	= Asset
To Interest and Dividends Account	[1]	= Revenue Gain

On the reverse side there will be adjustments for the following items accruing against the company—

(1) Claims admitted but not paid.
(2) Claims for surrenders admitted but not paid.

The entries will be—

(1) Claims Account	*Dr.*[2]	= Revenue Loss
To Claims Outstanding Account		= Liability
(2) Surrenders Account	*Dr.*[2]	= Revenue Charge
To Surrenders Unpaid Account		= Liability

Care must be exercised in dealing with this type of problem because *accruals* may be listed with the balances although they have not actually been made, in which case they must be eliminated from the Trial Balance; if they have already been dealt with, then the effect has been already given thereto in the accounts and the item

[1] The above are credits in the books, but debits in the First Schedule.
[2] The above are debits in the books, but credits in the First Schedule.

is either an asset, e.g. outstanding premiums, or a liability, such as claims unpaid.

Illustration. From the following information prepare Final Accounts in abridged form.

BALANCES

	Dr.	Cr.
	£	£
Premiums received		1,100
Claims paid	400	
Assets	4,000	
Liabilities		630
Fund-opening		600
Capital		2,000
Interest and Dividends received		180
Surrenders paid	110	
	£4,510	£4,510

		£
(1)	Premiums outstanding	45
(2)	Accrued Interest and Dividends	37
(3)	Claims admitted but not paid	32
(4)	Surrender Claims not paid	11

The Premiums Account will be credited with £45, making the premiums £1,145 and an asset of £45. The second item will be dealt with in a similar manner. Items 3 and 4 will be dealt with in the opposite direction, i.e. (3) Claims Account of £400 will be increased to £432 and a liability created of £32; similarly with item 4.

FIRST SCHEDULE

REVENUE ACCOUNT

Dr.		£	Cr.	£
Fund (Opening)		600	Claims (3)	432
Premiums (1)		1,145	Surrenders (4)	121
Interest and Dividends (2)	£ ?		Fund (Closing)	1,409
Less Income Tax	?			
		217		
		£1,962		£1,962

THIRD SCHEDULE

BALANCE SHEET

	£		£
Capital	2,000	Sundry Assets	4,000
Fund	1,409	Premiums outstanding (1)	45
Liabilities	630	Interest and Dividends outstanding (2)	37
Claims (3)	32		
Surrender Claims (4)	11		
	£4,082		£4,082

Illustration. On 31st December, 1952, the books of the Safety Assurance Co., Ltd., contained the following balances in respect of the personal accident insurance—

	£		£
Estimated Liability in respect of Outstanding Claims—		Medical and Legal Expenses in connection with Claims	2,500
On 31st December, 1951	3,500	Premiums . . .	75,000
On 31st December, 1952	7,600	Interest and Dividends— Amount received after deduction of Tax .	3,100
Provision for Unexpired Risks on 31st December, 1951	35,000	Profit on Sale of Securities.	350
Expenses of Management .	20,000	Reinsurance Premiums .	5,000
Commission . . .	12,500	Reinsurance Recoveries .	1,000
Claims Paid (*less* Reinsurances received) . .	38,500		

Prepare in detail the Personal Accident Insurance Account, reserving for unexpired risks 40 per cent of premiums, and treating the surplus, if any, as additional reserve

SAFETY ASSURANCE CO., LTD.

FIRST SCHEDULE

(*c*) FORM APPLICABLE TO ACCIDENT INSURANCE BUSINESS

REVENUE ACCOUNT FOR THE YEAR ENDING 31ST DECEMBER, 1952

Dr. *Cr.*

		£			£
Amount of Accident Insurance Fund at the beginning of the year—			Payment under policies, including medical and legal expenses in connection therewith (Net)[1]		41,000
Provision for unexpired risks	£35,000		Commission . . .		12,500
Total estimated liability in respect of outstanding claims	3,500		Expenses of Management.		20,000
Additional Reserve	—	38,500	Other Payments— Reinsurance Premiums.		5,000
Premiums . . .		75,000	Amount of Accident Insurance Fund at the end of the year—		
Interest, Dividends and Rents .	£ ?		Provision for unexpired risks, being 40% of premium income for the year . .	£30,000	
Less Income Tax . .	?	3,100	Total estimated liability in respect of outstanding claims	7,600	
Other Receipts— Profit on Sale of Securities . . .		350	Additional Reserve	1,850	39,450
Reinsurance recoveries		1,000			
		£117,950			£117,950

[1] It should be noted that where there are any reinsurance premiums, the claims figure will be reduced by the amount applicable to claims made against other insurance companies for which they have undertaken liability under such reinsurance.

The actuarial valuation is only legally required every five years, but as the risk is varying from year to year, it is advisable to adjust the reserve to suit the altered risk. This is done by basing the reserve on a percentage of the premiums plus a reserve for outstanding claims. The actual percentage (usually between 35 and 40 per cent) varies in each company according to the class of insurance affected and its usual practice.

It has already been mentioned that there will be separate Revenue Accounts for separate classes of insurance affected. The fact that there are two or three separate Revenue Accounts merely occasions more detailed work.

Illustration. From the following Trial Balance prepare Final Accounts in *correct form.*

Trial Balance	Dr.	Cr.
	£	£
Share Capital		200,000
British Government Securities	140,000	
Indian and Colonial Government Securities	60,000	
Foreign Government Securities	20,060	
Deposit with High Court	40,000	
Reserve for Income Tax		10,000
Interest and Dividends		15,000
Agents' Balances	12,500	
Claims admitted but not paid		32,000
Outstanding Interest and Dividends	1,500	
Bank	68,780	
Fire Insurance Fund		7,000
Profit and Loss		31,000
Premiums—		
Fire		27,000
Life		102,000
Claims paid and outstanding—		
Fire	11,000	
Life	71,000	
Commission—		
Fire	1,100	
Life	8,800	
Expenses of Management—		
Fire	9,200	
Life	13,460	
Taxation	14,600	
Life Fund		48,000
	£472,000	£472,000

Pending the quinquennial valuation in respect of the life branch a reserve of 45 per cent of premium income is to be made in the life and fire branches.

The funds will be those at the commencement. If all the Revenue

Accounts had been closed off prior to the extraction of the Trial Balance the "Funds" would be closing funds.

First Schedule

(a) [1] Form Applicable to Life Assurance Business

Dr. Revenue Account for the Year Ending .... *Cr.*

		£			£
Amount of Fund at beginning of year . .		48,000	Claims paid and outstanding— by Death . £ ? by Maturity . ?		71,000
Premiums . . .		102,000	Commission . . .		8,800
			Expenses of Management		13,460
			Provision for unexpired risks, being 45% of the premium income for the year		45,900
			Transfer to Profit and Loss Account . .		10,840
		£150,000			£150,000

First Schedule

(b) Form Applicable to Fire Insurance Business

Dr. Revenue Account for the Year Ending .... *Cr.*

		£			£
Amount of Fund at the beginning of year . .		7,000	Claims paid and outstanding		11,000
Premiums . . .		27,000	Commission		1,100
			Expenses of Management .		9,200
			Provision for unexpired risks being 45% of the Premium Income for the year .		12,150
			Transfer to Profit and Loss Account . . .		550
	£	34,000		£	34,000

Second Schedule

Dr. Profit and Loss Account for the Year Ending ...... *Cr.*

		£			£
Balance	b/f	31,000	Taxation on Interest and Profits— Income Tax . ? Profits Tax . ?		14,600
Interest, Dividends and Rents not carried to any other Account (gross)		15,000	Balance carried forward as per Third Schedule .		42,790
Transfer from Fire Insurance Account . .		550			
Transfer from Life Assurance Account . .		10,840			
	£	57,390		£	57,390

[1] Actually the form is subdivided into business done within the United Kingdom and out of the United Kingdom.

Third Schedule

Balance Sheet of the .... on the ....

		£			£
Capital authorized and issued—			*Fixed Assets*—		
200,000 shares of £1 each, fully paid .		200,000	Mortgages on Property in the U.K. .		
Revenue Reserves—			Mortgages on Property outside the U.K.		
Profit and Loss Account .	£42,790		Loans on—		
Taxation	10,000	52,790	Life Interests		
Insurance Funds—			Reversions		
Life Assurance . .	£45,900		Stocks and Shares . . .		
Fire Insurance . .	12,150		Investments—		
Accident	—		Deposit with High Court (specified)		40,000
Sinking Fund and Capital Redemption . .	—	58,050	British Government Securities .		140,000
Liabilities and Provisions—			Indian and Colonial Government Securities		60,000
Claims admitted or estimated, but not paid . .	£32,000		Foreign Government Securities .		20,060
Creditors	—	32,000	Debentures		
			Preference and Guaranteed Stocks and Shares		
			Ordinary Stocks and Shares .		
			Rent Charges		
			Freehold Ground Rents . .		
			Leasehold Ground Rents . .		
			House Property . . .		
			Reversions		
					260,060
			Current Assets—		
			Agents' Balances . .	£12,500	
			Outstanding Premiums .		
			Outstanding Interest, Dividends, and Rents .	1,500	
			Bills Receivable		
			Cash: on Deposit		
			in Hand and on Current Account	68,780	
					82,780
			Other Assets (specified)		
		£342,840			£342,840

The Balance Sheet is given in more detail than is required by the question in order to show the main contents and *sequence*.

Valuation Balance Sheet. The quinquennial Valuation Balance Sheet (Fourth Schedule) has no bearing upon the double entry. As the amount of the Life Assurance Fund is merely a balance, it is necessary to have prepared, at least once every five years, a valuation Balance Sheet, the main object of which is to show—

(*a*) the true liabilities upon unmatured risk in the life and accident departments, and

(*b*) the true profits,

and to apportion the Fund accordingly.

The latter, in a proprietary company, are usually divided between the policy holders and the shareholders in the manner indicated in the Valuation Balance Sheet. The policy holder is not usually entitled to an immediate cash payment of the face value of the bonus, e.g. a bonus declared in 1952 of £40 would be added to the value of the policy and would normally be payable along with the lump sum when the policy matures (say) 10 years later or on death if earlier. Obviously £40 due at maturity date is worth considerably less than the like amount paid immediately. Should the bonus

be paid on declaration, the entry would be as below, assuming the cash value of the above-mentioned bonus of £40 to be £25: Bonus Account, debit £25; Cash Account, credit £25. Where the bonus is applied in reduction of premium, the entry would be (assuming annual premium £30)—

Bonus Account, debit £25; Premium Account, credit £30;
Cash Account, debit £5.

The bonus is a "Loss" item, and hence appears on the right-hand side of the Revenue Account. No entry would be necessary should the bonus not be claimed in cash, the liability therefor being brought into account in the Valuation Balance Sheet.

The liabilities side consists of the net liability as certified by the actuary; the assets side consists of the balance of the life fund and annuity fund as shown by the Accounts, the surplus balance being available for the policy holders and the shareholders. A deficiency is quite possible, but very unlikely, as assurance companies, like banks, are very conservative and sound in their management.

Illustration. At the quinquennial valuation on 31st December, 19.., the actuary's certificate disclosed the net liability on policies and annuities at £454,600.

The Revenue Accounts for the five years consisted of—

	£
Bonus in Cash	9,000
Bonus in Reduction of Premiums . .	400
Surrenders	15,000
Premiums	210,000
Interest, Dividends and Rents . . .	100,000
Claims	215,000
Expenses of Management	20,000
Commission	10,000
Annuities	22,000
Consideration for Annuities Granted . .	110,000
Life Assurance Fund as per last quinquennial valuation	396,000
There had been paid an Interim Bonus of .	10,000

The allocation for year of surplus—

25% Shareholders. 70% Policy-holders. 5% to be carried forward.

Prepare consolidated Revenue Account and Valuation Balance Sheet.

CONSOLIDATED REVENUE ACCOUNT FOR FIVE YEARS ENDING 31ST DECEMBER, 19..

Dr. *Cr.*

		£			£
Life Assurance Fund (Opening) . .		396,000	Claims		215,000
Premiums . . .		210,000	Surrenders		15,000
Consideration for Annuities Granted . .		110,000	Annuities		22,000
Interest Dividends and Rents . . £?			Bonus: Cash		9,000
Less Income Tax. ?			,, : Reduction of Premiums . .		400
		100,000	Commission		10,000
			Expenses of Management.		20,000
			Life Assurance Fund (Closing) . . .		524,600
		£816,000			£816,000

Fourth Schedule
Valuation Balance Sheet of
as at 31st December, 19..

Dr.	£		*Cr.* £
To Net Liability under Life Assurance Transactions (as per Summary Statement provided in Fourth Schedule)	454,600	By Life Assurance and Annuity Funds (as per Balance Sheet, Third Schedule)	524,600
,, Surplus	70,000	,, Deficiency	*nil*
	£524,600		£524,600

	Total	Policy Holders 70%	Share-holders 25%	Carry Forward 5%
Allocation of Surplus—	£	£	£	£
Surplus (as above) .	70,000			
Add Interim Bonus paid .	10,000			
	80,000	56,000	20,000	4,000
Less Interim Bonus paid .	10,000	10,000		
	£70,000	£46,000	£20,000	£4,000

Illustration. As on 30th June, 19.., the All England Assurance Co., Ltd., transferred to the Empire Assurance Co., Ltd., that part of its industrial life assurance business which was carried on in the colonies.

It was agreed that the transfer should be made on the basis of an actuarial valuation on prescribed tables, and the value came to £2,500.

It was also agreed that £500 should be paid for the goodwill of the business transferred, and that both sums bear interest at 4 per cent per annum from 30th June, 19.., to 31st July, 19.., when payment was made.

Journalize the entries relative to the above in the books of the All England Co. Ignore income tax.

Journal

19..			£	s.	d.	£	s.	d.
June 30	Industrial Life Fund . . *Dr.*		2,500	0	0			
	To Empire Assurance Co., Ltd. .					2,500	0	0
	Being transfer of Industrial Life Fund relative to colonies as per actuarial valuation and agreement dated ...							
	Empire Assurance Co., Ltd. . *Dr.*		500	0	0			
	To Reserve[1]					500	0	0
	Being amount charged to Empire Assurance Co., Ltd., for goodwill as per agreement dated							
July 31	Interest on Industrial Life Fund Investments . . . *Dr.*		8	6	8			
	To Interest on Reserve Fund Investments.					1	13	4
	To Empire Assurance Co., Ltd.[2].					6	13	4
	Being interest at 4 per cent per annum for one month on £2,000.							

[1] This amount would be credited to Goodwill Account if an account existed relative to the amount taken over, any profit or loss being transferred to Reserve.

[2] The settlement of £2,006 13s. 4d. due to Empire Assurance Co., Ltd. will be passed through the Cash Book in the usual way.

Notes. (1) If the investments representing the fund are taken over, the Empire Assurance Co., Ltd., will be debited and investments credited, any profit or loss being transferred to Reserve.

(2) It should be clearly observed that the Empire Co. is taking over a LIABILITY; also that it is assumed the value of the fund is the same in the books of the vendor.

Illustration. The books of the Safe Assurance Co., Ltd., showed on 31st December, 19.., the following—

	£
Life Assurance Fund	2,200,000
Investments	1,570,000
Investments Provision	100,000

On that date effect was given in the books to (1) an actuarial valuation, bringing out the liability in respect of life policies in force at £1,900,000, and to (2) a revaluation of investments at £1,400,000, by writing them down.

A reversionary bonus of £2 per cent was declared on policies for £12,000,000, policy holders being offered the alternative of taking the present cash value, 13s. 4d. per cent, in cash. The latter option was exercised in respect of one-fourth in value of the policies.

Show by Journal entries the records in the books.

JOURNAL

Date	Particulars		£	£
19.. Dec. 31	Life Assurance Fund . . . . *Dr.* To Profit and Loss Account . . Being decrease in liability upon revaluation.		300,000	300,000
	Profit and Loss Account . . *Dr.* To Investments Provision . . Being appropriation of amount necessary to provide for depreciation of assets on revaluation.		70,000	70,000
	Investments Provision . . . *Dr.* To Investments Account . . . Being amount written off investments on revaluation.	[1]	170,000	170,000
	Profit and Loss Account . . . *Dr.* To Sundry Policy holders . . Being allocation of a cash bonus of 13s. 4d. per hundred pounds, for £3,000,000 on which policy holders have exercised their option of a cash bonus.		20,000	20,000
	Sundry Policy holders . . . *Dr.* To Cash . . . . . . Being payment of cash bonus as above.		20,000	20,000

[1] Alternatively, the Investments Provision may be left intact although the question states that the Assets are to be *written down*. [See next page.]

JOURNAL—(*contd.*)

		Dr. £	Cr. £
	Profit and Loss Account . . . *Dr.*	60,000	
	To Life Assurance Fund . .		60,000
	Being allocation of a reversionary bonus of £2 per cent on policies for £9,000,000, the present worth of such bonus being 13s. 4d. per hundred pounds.		

The resultant position is as follows—

	£
Life Assurance Fund—	
Balance as per question	2,200,000
Less decrease on revaluation	300,000
	1,900,000
Add present worth of reversionary bonus on policies for £9,000,000 (see below)	60,000
	£1,960,000

	£	£
Profit and Loss Account—		
Profit, per valuation		300,000
Less Increase in Investments Provision . .	70,000	
Bonus in Cash	20,000	
Present worth of reversionary bonus (as above)	60,000	150,000
		£150,000

Alternatively, there apparently being one class of business only, a separate Profit and Loss Account is not required, all entries being made in the Life Assurance Fund which will amount to £2,110,000, as follows—

	£	£
Net Liability on Policies	1,900,000	
Present worth of reversionary bonus on policies for £9,000,000	60,000	
		1,960,000
Profit	300,000	
Less Bonus on policies for £12,000,000 (£80,000) and Investments Provision (£70,000) . .	150,000	150,000
		£2,110,000

Compulsory Winding Up. Under Sect. 222 (*e*) of the Companies Act, 1948, any company may be wound up by the Court if it is unable to pay its debts. Under Sect. 3, Assurance Companies Act, 1946, an assurance company carrying on general business is to be deemed to be unable to pay its debts if the value of its assets does not exceed the amount of its liabilities (including all contingent and prospective liabilities except in respect of share capital) by the greater of (*a*) £50,000 or (*b*) one-tenth of the general premium income (net after reinsurances) in its last preceding financial year. This section does not operate in the first two years of carrying on a general business or such longer period as the Board of Trade may allow.

CHAPTER XXIX

INSURANCE CLAIMS

Loss of Profit Insurance. This type of insurance has for its purpose the indemnification of the insured for losses arising from the suspension, wholly or in part, of the activities of the business caused by fire.

Policies vary considerably according to circumstances applicable to the particular business, but the following conditions are generally contained in the policy.

(1) The period of indemnity is fixed in the policy.

(2) The basis of compensation is computed by reference to a percentage which the sales are supposed to earn. This percentage multiplied by the amount of "short" sales—the amount by which the sales have declined because of the fire as compared with those of the corresponding months in the preceding year—gives the amount due to the insured.

(3) The compensation so due is found by multiplying the amount of the "short" sales by the lower of the two percentages—

$$(a)\quad \frac{\text{Profits} + \text{Standing Charges (for the last accounting period)}}{\text{Sales (for the last accounting period)}} \times 100$$

$$(b)\quad \frac{\text{Amount Insured}}{\text{Sales (for the year preceding the fire)}} \times 100$$

(4) The insurance company will admit this claim only if, in addition, there is an admission of liability for loss of property by fire.

(5) In no case will the liability of the insurance company exceed the amount insured; further, the insurance company will not admit liability to a greater extent than the loss arising if the sales were (in the period of indemnity) absolutely nil.

(6) Although a period is fixed as in (1), the liability of the insurance company will not extend beyond the period subsequent to the fire during which the diminished activities continue, e.g. the period for indemnity might be fixed at six months, but if the fire was not a serious one, the interruption of normal business activity may be for two months only; as a result, the liability of the insurance company will continue for the latter period and NOT for six months.

(7) There is usually a clause for indemnity to cover an increase of standing charges due to the fire, in order to maintain sales, otherwise they must not exceed those in the year preceding the fire.

The most important point for examination purposes is contained in (3), and, assuming the restrictions already mentioned are not operative, the procedure will be as follows—

(i) Compare the sales for the period after the fire with the corresponding period of the preceding year; the deficiency is the "short" sales.

For instance, if a fire occurred on 31st January, 1953, and the period of indemnity was for three months, a comparison would be made of the sales for February, March, and April, 1953, with those of February, March, and April, 1952, in order to arrive at the "short" sales.

(ii) Ascertain which of the two percentages is applicable. To do this, it is necessary to ascertain profits plus standing charges and divide by the sales for the last accounting period. This fraction will be multiplied by 100 to convert the result into a percentage.

This percentage must then be compared with the one arrived at by dividing the amount insured by the sales for the year which immediately precedes the fire. This fraction, as before, will be multiplied by 100.

The lower of the two results will form the basis of computing the compensation for consequential loss of profits. All that is required to be done at this stage is to multiply the "short" sales for the period in (i) by the percentage arrived at in (ii).

The following simple illustration is appended to show the principle.

Illustration. The loss of sales for the period subsequent to the fire is £10,000.

The percentages resulting from the formulae given are (*a*) 10 per cent; (*b*) 12 per cent.

Hence the claim will be: 10 per cent of £10,000 = £1,000.

Some confusion exists in the minds of students in respect of the calculations of the percentages. It is always necessary to have four sets of figures as follows—

(1) Sales for year immediately before the fire.
(2) Sales for the ordinary financial year.
(3) Amount insured.
(4) Standing charges.

It should be of assistance to students if it is remembered that the "profits plus standing charges" basis must be taken from the accounting period, not the year before the fire, because there will probably be no completed accounts for the latter period. Further, it must be kept clearly in mind that this computation is merely necessary to fix the compensation for short sales arising AFTER the fire.

Illustration. Accounts are drawn up yearly to 30th November. The net profits for the year to 30th November, 1952, were £6,000 after debiting standing charges of £3,000 (sales for this period were £180,000). A fire occurred on 1st March, 1953, the period of indemnity being three months. It is ascertained that the sales for the year to 28th February, 1953, were £230,000 (of which £60,000 were for three months ended 31st May, 1952). The amount insured

was £15,000. The sales for the three months to 31st May, 1953, were £15,000. Prepare claim.

The claim would (subject to any special clauses in the policy) be as follows—

(1) Ascertain the "short" sales—

	£
Sales 3 months to 31st May, 1952 . .	60,000
" " " 1953 . .	15,000
∴ "Short" Sales. . . .	£45,000

(2) Ascertain the required percentage, being the lower of the undermentioned—

(*a*) $\dfrac{\text{Profits (6,000) + Standing Charges (3,000)}}{\text{Sales (180,000)}} \times 100 = \underline{5\%}$

(*b*) $\dfrac{\text{Amount Insured (15,000)}}{\text{Sales (230,000)}} \times 100 = \underline{6{\cdot}52\%}$

Hence the claim will be—

5% [i.e. the lower of (*a*) and (*b*)] × £45,000 = £2,250

Average Clause. The settlement of insurance claims involves a knowledge of many technical matters beyond the scope of the accountant. The student should comprehend the significance of an average clause in an insurance policy. By such a clause an insurer will, in case the value of the property insured exceeds the amount insured, be responsible only for the same proportion of the loss as the amount insured bears to the value of the property.

The insured is deemed to be his own insurer for the excess of the value of the property over the amount insured.

Illustration. X insures his property for £1,500, it being worth £2,500. The property being totally lost, show the liability of the insurer.

Insurer's liability— $\dfrac{1{,}500}{2{,}500} \times £2{,}500 = \underline{£1{,}500}$

If the damage done were £800 under the same conditions, the liability of the insurer would be three-fifths of £800 = £480.

Loss of Stock Claims. Subject to verification of facts an insurance company will, in consideration of a premium, agree to indemnify a trader in respect of loss of stock by fire or other causes.

Where it is not possible to verify the actual stock lost, a frequent plan is to construct a "Trading Account" assuming a given rate of gross profit earned on sales and therefrom compute the stock at end, that is, the stock (on the assumption given) that would be in existence but for the cause of the loss of stock, e.g. fire.

The claim will arise in respect of such loss of stock, less any part saved at salvage price.

In the examinations the percentage results usually "work out" in round sums, but the practical aspect should (in a note) be commented on in answering this type of question. Apart from the fact

that, in practice, the exact percentage result will rarely arise, except, for instance, in slow-moving and expensive lines (motor cars, jewellery) and nearly so in branded and fixed priced goods (e.g. patent medicines, cigarettes), many factors will arise to upset the percentage result such as—

(1) End season sales at "cut" prices.

(2) Goods likely to perish or deteriorate after a short period sold off at reduced prices.

(3) Circumstances requiring goods to be purchased locally to fulfil urgent orders.

(4) Changes beyond executive control, e.g. in the tobacco trade where the increase of duty is passed on to retailer without permitting of retail price to be increased by more than the extra duty.

(5) Pilferage.

In preparing a claim for submission to an insurance company in respect of stock lost by fire where a "Trading Account" is to be constructed, the following information would be required—

(1) Basis of previous stocktakings, particularly as regards consistency of valuation.

(2) The stock value at the date of the last Balance Sheet (or nearer date e.g. where accounts are prepared periodically and stock actually taken or based on reliable estimates).

(3) The total purchases of goods from the date used in (2) to the date of the fire, care being taken to exclude therefrom goods invoiced but not delivered to the premises where the fire has occurred.

(4) The total sales of goods for the period indicated in (3).

(5) The value of stock salvaged.

(6) The average rate of gross profit made in recent years, having regard to any factor likely to render such average rate unreliable, e.g. change in nature and type of goods sold; effect of price controls and orders; variations in wholesale prices not yet adjusted to consumer; and variations of *rate* of gross profit, e.g. through wholesale price increase exactly passed on to consumer, or owing to the preponderance of sales of one class of goods carrying a gross profit rate higher or lower than another class, in a short term period, that is where the incidence of sales per month or other short period as between articles giving highly differential rates of gross profit, is subject to variation, e.g. in the month of January sales of goods carrying a low rate of gross profit might be at their peak, whilst those with a high rate of gross profit might be at their "low," owing to seasonal influences.

In addition, the precise terms of the policy would have to be examined, particularly as regards the "average clause," which would operate to the disadvantage of the insured if he was not fully covered. If the value of the stock was, say £10,000 and the insured was covered for £8,000, then the average clause would operate so that the insured could claim only for eight-tenths of his loss, even if it was less than £8,000.

Illustration. A fire occurred on the premises of a merchant on 25th July, 19... The value of the stock salved was £170.

The books disclosed that on 1st March, 19.., the stock was valued at £4,020; the net purchases to the date of the fire amounting to £25,180, and the net sales to £32,000.

The average gross profits for the last three years (the agreed basis) were 15 per cent on sales. Prepare claim.

TRADING ACCOUNT FOR THE PERIOD 1ST MARCH TO 25TH JULY, 19..

Dr. | *Cr.*

19..		£	19..		£
Mar. 1	To Stock	4,020	July 25	By Sales (Net)	32,000
July 25	,, Purchases (Net)	25,180		,, Stock	2,000
	,, Gross Profit	4,800			
	£	34,000		£	34,000

FIRE CLAIM

	£
Loss of Stock per Trading Account	2,000
Less Value of Salvage	170
Balance due from Insurance Company	£1,830

Notes. (*a*) There may be special clauses in the insurance policy to which the claim must adhere. The insurance company are entitled to replace the actual stock which, owing to falling prices, may be less than £1,830 in value.

(*b*) The fact that a uniform gross profit of 15 per cent on sales is earned every year does not necessarily indicate that such a uniformity exists in every section of the business or is uniformly earned during every part of the year; e.g. using simple figures, a 20 per cent rate may be earned during the first half of the year and 10 per cent for the second half.

If the question had stated that the average gross profits for the last three years were $\frac{3}{17}$ on cost of goods sold, it would merely be necessary to translate the fraction in terms of *sales*, i.e. $\frac{3}{20}$ = 15 per cent.

It may be noted that the same principle is applied in stock estimating systems. If there had been no fire, the statement of the approximate stock for the period, assuming it to be for one month, would be as follows—

ESTIMATE OF STOCK

		19.. March			19.. April		19.. May	
		£	£		£	£	£	£
Balance at commencement	b/f	4,020		b/f	2,000			
Purchases (net)		25,180						
			29,200					
Sales (net)		32,000						
Less Gross Profit		4,800						
			27,200					
Balance at end	c/f		£2,000					

The figures for the succeeding months will be inserted in due course.

Illustration. On 15th June, 1953, the premises of Beech and Pine were destroyed by fire, but sufficient records were saved from which the following particulars were ascertained—

	£
Stock at Cost, 1st January, 1952	7,350
Stock at Cost, 31st December, 1952	7,960
Purchases, *less* Returns, year ended 31st December, 1952	39,800
Sales, *less* Returns, year ended 31st December, 1952	48,700
Purchases, *less* Returns, 1st January, 1953, to 15th June, 1953	16,200
Sales, *less* Returns, 1st January, 1953, to 15th June, 1953	23,120

In valuing the Stock for the Balance Sheet at 31st December, 1952, £230 had been written off certain stock which was a poor selling line, having cost £690. A portion of these goods were sold in March, 1953 at a loss of £25 on original cost of £345. The remainder of this stock was now estimated to be worth the original cost. Subject to the above exception, gross profit had remained at a uniform rate throughout.

The Stock salvaged was £580.

Show the amount of the claim.

Rate of Gross Profit based upon the accounts for the year ended 31st December, 1952—

	£	£
Sales, *less* Returns		48,700
Less Opening Stock	7,350	
„ Purchases, *less* Returns	39,800	
	47,150	
Less Closing Stock (31st December, 1952)	7,960	
		39,190
		9,510
Add amount of Stock written off at 31st Dec., 1952		230
Gross Profit on normal Sales—20%		£9,740

Value of Stock 15th June, 1953, based on sales from 1st January, 1953, to 15th June, 1953—

	Normal £	*Abnormal* £	
Sales	22,800	320	
Gross Profit—20% on normal Sales	4,560	90	(see next page)
Cost of Sales	£18,240	£230	
Stock, 31st December, 1952	7,500	460	
Purchases	16,200	—	
	23,700	460	
Less Cost of Sales	18,240	230	
	5,460	230	
Add Old Stock	345	115	(Appreciation)
	5,805	£345	
Less Salvage	580		
Value of Stock for claim	£5,225		

Notes. (1) For the purpose of ascertaining normal Gross Profit, the depreciation of the abnormal Stock must be eliminated.

(2) When the account is built up, the total commencing Stock must be split as between—

	£
(*a*) "Normal"	7,500
(*b*) "Abnormal" [£690 – £230]	460
Balance Sheet, 31st December, 1952	£7,960

(3) In regard to the "abnormal" Stock, it is obvious that half was "cleared" for £320, showing a profit (in terms of the written down value at 31st December, 1952) of £90; thus—

	Stock Sold		*Stock Unsold*	*Total*
	£		£	£
Cost Price	345		345	690
Less written off, 31st Dec., 1952	115		115	230
	230		230	£460
Sale	320	Appreciation	115	
Profit	£90	Stock, 15th June, 1953	£345	

(4) The question arises as to whether the restoration of the £115 written off is justified, seeing that such Stock is *still* unsold at 15th June, 1953, and would, therefore, be a matter requiring a satisfactory explanation to the insurance company.

(5) It is assumed that the write off of £230 made in December, 1952, was applicable uniformly to the whole of the abnormal Stock, and these goods were in units of equal value.

Book-keeping Entries. The amount of the agreed claim will be debited to the insurance company and

(*a*) Stock lost—credited to Trading Account.

(*b*) Expenses in connection with the claim and of repairing DAMAGED assets—credited to the appropriate expense accounts (thus eliminating or reducing the debit against expenses incurred).

(*c*) Assets lost—credited to assets accounts and the balance of

(1) a loss debited to Loss of Asset Account;

(2) a profit credited to Profit and Loss Account or Reserve.

Salved stock, if retained by the insured, will be debited to a Salved Stock Account and credited to the Trading Account. As the LOSS (i.e. the difference between the true value and salved value) has been debited to the insurance company and credited to Trading Account (see (*a*)), the latter account is in credit for the same amount of stock as if no loss had occurred.

If such salved stock is taken over by the insurance company, there will be a correspondingly increased loss to the insured which will augment the amount of the claim in (*a*), so that the full loss will be included in the claim and credited to Trading Account; hence the entries in the foregoing paragraph will not arise.

EXAMINATION PROBLEM

Importers, Ltd , suffered loss by fire Claims made against and admitted by Credential Insurance Co , Ltd , and expenditure incurred, were—

		£		£		£
Loss of profits .	claimed	6,000	admitted	4,000		
Stock Damaged .	,,	4,000	,,	2,000		
Stock Destroyed .	,,	5,000	,,	4,000		
Building Damaged .	,,	1,200	,,	1,000	repairs cost	1,100
Fittings Destroyed .	,,	1,000	,,	900	renewal cost	950
Fire Expenses .	,,	80	,,	80	cost	80
		£17,280		£11,980		

The amounts claimed and admitted for loss of profits were half in respect of loss of profits in 1951 and 1952, and half in respect of advertising expenditure, put to suspense in 1950, which it was proposed to write off equally in 1951, 1952, and 1953 and which had been rendered partly useless

Renewals of fittings (which originally cost £800 and had not been written down) and repairs to buildings were completed by and paid for on 31st December, 1951, the expenses were also paid on that date

Show by Journal entries the records that should be made in the books o' Importers, Ltd , at the end of 1951

(*Institute of Chartered Accountants' Final*)

JOURNAL

		£	£
	Stock Destroyed . . *Dr*	5,000	
	,, Damaged . . . . . *Dr*	4,000	
	To Trading Account . .		9,000
	Being value of stock transferred		
	Credential Insurance Co , Ltd . . *Dr*	11,980	
	To Profit and Loss Account		1,000
	,, ,, ,, Suspense		1,000
	,, Advertising Suspense .		2,000
	,, Stock Damaged .		2,000
	,, Stock Destroyed .		4,000
	,, Buildings		1,000
	,, Fittings . .		900
	,, Fire Expenses .		80
	Being sundry claims admitted by insurance company		
	Profit and Loss Account . . . *Dr*	3,100	
	To Stock Damaged .		2,000
	,, Stock Destroyed .		1,000
	,, Buildings . . .		100
	Being claims *re* stock and excess of repairs not admitted and now written off		
	Salvaged Stock . . . . . *Dr*	?	
	To Profit and Loss Account . .		?
	Being valuation of damaged stock.		

Notes. (1) The Profit and Loss Suspense Account should be carried forward and credited in 1952.

(2) Advertising Suspense should be written off as early as practicable.

(3) Cash received will be credited to the Insurance Co., and that paid for repairs debited to Buildings and Fittings Accounts respectively.

(4) There is a profit on fittings of £100 which may be transferred to reserve.

Own Insurance. Large companies often prefer to carry a proportion of risk themselves, thus reducing the amount payable in respect of insurance premiums. It is highly desirable, however, to allocate a certain proportion of the profits for the purpose of providing a fund that can be used should a loss (which is not fully covered by insurance) occur. As cash will be required to acquire an asset in substitution for the one destroyed, such reserve is usually invested in good marketable securities. Much depends on chance as to the success of one's own insurance, as a loss may be incurred in the very early stages of the building up of the fund. It should not be forgotten that any loss chargeable to the fund will be the book value less depreciation, e.g. a car has a book value of £200 on 1st January, 1951, and it is totally destroyed on December 31st, 1952; it can be discerned immediately that the real loss is somewhat less than £200, as the car will have diminished in value by use and obsolescence. If £30 represents the depreciation, then the amount of the loss is only £170.

Illustration. Scarsdale Motor Co., Ltd., insured its motors for four-fifths of their value, providing for the uncovered risk by a yearly appropriation to an insurance reserve of 10 per cent of one fifth of the written down value, commencing at the beginning of the FIRST year. At 1st January, 1952, the balance of Motor Account (after providing for depreciation at the rate of 10 per cent per annum on the diminishing balance) is £100,000, the insurance reserve having been credited with four annual contributions totalling £9,434. The reserve has been invested in £12,560 3½ per cent Loan at 70, 75, 78, and 80 in the respective years.

On 30th September, 1952, an accident occurred causing a total loss of one of the motors, standing in the books at the **commencement of the first year** at £2,743 to nearest £. A cheque was received from the insurance company for £1,584, being the agreed sum due under the claim, less 1 per cent commission. The motor is not to be replaced, and on 31st December, 1952, the fifth contribution is made to the insurance reserve and the required sum invested in 3½ per cent Loan at 85. There have been no additions to, or sales of, motors within the foregoing period. Brokerage and interest may be ignored. Show Journal entries without narratives, dealing with the claim and the fifth appropriation to the insurance reserve, assuming no other changes in the Motor Account. All calculations are to be made to the nearest £.

JOURNAL

			£	£
1952 Sept. 30	Motor Loss Account	*Dr.*	2,000	
	To Motor Account			2,000
	Depreciation Account	*Dr.*	150	
	To Motor Loss Account . . .			150
	Insurance Company	*Dr.*	1,600	
	Insurance Reserve[1]	*Dr.*	400	
	To Motor Loss Account . . .			1,850
	,, General Reserve[1] . . .			120
	,, Insurance Reserve[1] . . .			30
	Profit and Loss Account . .	*Dr.*	16	
	To Insurance Company (1% of £1600)			16
Dec. 31	Depreciation	*Dr.*	9,800	
	To Motor Account			9,800
	Profit and Loss Account . .	*Dr.*	1,764	
	To Insurance Reserve . . .			1,764
	InsuranceReserve Investment .	*Dr.*	1,394	
	To Broker			1,394

Note. The written down value of the motor lost at 30th September, 1952, was £2,000, *less* £150 (10 per cent on £2,000 for nine months) = £1,850, of which one-fifth (£370) is applicable to the Motor Company.

The depreciation at 31st December, 1952, is arrived at as follows—

	£
Motor Account at 1st January, 1952 . .	100,000
Less Motor cost	2,000
	£98,000
10 per cent for year	£9,800

The transfer to Insurance Reserve is computed as follows—

	£
Book Value of Motors at 31st December, 1952 .	98,000
Less Depreciation	9,800
Balance at 31st December, 1952, *after* depreciation	£88,200

The risk carried by the motor company = $\frac{1}{5} \times$ £88,200 = £17,640.
Annual allocation is 10 per cent of risk = 10% × £17,640 = £1,764.

The cash to be invested is arrived at as follows—

The investment at 1st January, 1952, was built up in the three preceding years by investing a similar amount in $3\frac{1}{2}$ per cent Loan at the prices indicated in the question, representing the annual allocations to the Insurance Reserve. It will be seen that each year

[1] The insurance company, according to the question, indemnifies the insured for the book value of the lost motor at the commencement of the year of loss. Thus, four-fifths of the depreciation (£120) written off represents a profit, which will be transferred to general reserve. The remaining one-fifth depreciation (£30) will be transferred to the credit of insurance reserve.

10 per cent of $\frac{1}{8}$ of the Motor Account is transferred to the latter account. The allocations are as shown on the next page.

The Investment Account as at 1st January, 1952, will be as follows—

Dr. INVESTMENT *Cr.*

			Nominal					Nominal	
1952 Jan 1	To Balance .	b/d	£ 12,560	£ 9,434					

The Insurance Reserve Account will be as follows—

Dr. INSURANCE RESERVE *Cr.*

1952			£	1952			£
Sept 30	To Sundries . .		400	Jan 1	By Balance . . .	b/d	9,434
Dec 31	,, Balance	c/d	10,828	Sept 30	,, Sundries .		30
				Dec 31	,, Transfer from Profit and Loss Account		1,764
		£	11,228			£	11,228
				1953 Jan 1	By Balance . .	b/d	10,828

The amount, therefore, to be invested is £10,828 less £9,434 = £1,394.

This sum invested will buy £1,394 × $\frac{100}{85}$ Nominal $3\frac{1}{2}$ per cent Loan = £1,640; hence, the Investment Account as at 1st January, 1953, will be as follows—

Dr. INVESTMENT *Cr.*

			Nominal					Nominal	
1952			£	£					
Jan 1	To Balance	b/d	12,560	9,434					
Dec 31	,, Broker		1,640	1,394					
			£14,200	£10,828					

Note. The fifth contribution has been made (in accordance with the question) on 31st December, 1952, not 1st January, 1953

Compensation Claims. Claims may arise—

(1) By acquisition of premises by local authorities for the purposes of widening of streets, slum clearance, purchase of property for new buildings, etc., resulting in—

(2) Removal expenses.

(3) Increased rental.

(4) Damage (or loss) in respect of fittings and fixtures.

(5) Loss in connection with the sale, removal of or damage to stock and other assets.

Dr **Motor** *Cr.*

Year			£	Year			£	Allocation to Insurance Reserve	Nominal Amount Invested
1	To Cash . . .		137,174	1	By Depreciation . . .		13,717	$\frac{1}{50} \times$ £137,174 = £2,743	£2,743 $\times \frac{100}{70}$ = £3,919
					,, Balance . . .	c/d	123,457		
			£137,174				£137,174		
2	,, Balance . .	b/d	123,457	2	,, Depreciation . . .		12,346	$\frac{1}{50} \times$ 123,457 = 2,469	2,469 $\times \frac{100}{75}$ = 3,292
					,, Balance . . .	c/d	111,111		
			£123,457				£123,457		
3	,, Balance .	b/d	111,111	3	,, Depreciation . . .		11,111	$\frac{1}{50} \times$ 111,111 = 2 222	2,222 $\times \frac{100}{78}$ = 2,849
					,, Balance . . .	c/d	100,000		
			£111,111				£111,111		
4	,, Balance. . .	b/d	100,000	4	,, Motor Loss Account .		2,000	$\frac{1}{50} \times$ 100,000 = 2,000	2,000 $\times \frac{100}{80}$ = 2,500
					,, Depreciation . . .		9,800		
					,, Balance . . .	c/d	88,200		
			£100,000				£100,000	Total Reserve at the beginning of the 4th Year[1] £9,434	£12,560
5	,, Balance . .	b/d	88,200					$\frac{1}{50} \times$ 88,200 = £1,764	

[1] I.e. 1st January, 1952.

(6) Increased cost of new leases or loss of value of unexpired portion of lease.

(7) Loss of goodwill.

(8) Loss in connection with discontinued use of old address, e.g. discarding advertising blocks containing old address.

(9) Possible inability to complete contracts within the stipulated period.

(10) Loss of sub-rentals.

The claim may or may not be increased by interest till settlement.

CHAPTER XXX

BANKRUPTCY

A PERSON who is in financial difficulties usually finds it necessary to call his creditors together; whereupon he will, unless other arrangements are made, either have to execute a deed of arrangement, or will be formally adjudicated bankrupt. The law requires certain evidences of unwillingness or inability to pay creditors before the formality (with resultant disabilities) of bankruptcy can be imposed upon the debtor, although it should be remembered that the sole fact of inability to pay debts as they arise, i.e. insolvency, is not synonymous with bankruptcy, inasmuch as a certain procedure must be followed before a state of bankruptcy can exist.

The importance of the subject from an accounting point of view lies in the necessity for the preparation of a Statement of Affairs, Deficiency Account, and the accounts for winding up the affairs of the bankrupt. The law relating to bankruptcy will be considered only in so far as it is relevant to the accountancy aspect.

Statement of Affairs. The debtor (who invariably invokes professional assistance) must prepare a Statement of Affairs, setting out the assets and liabilities in a certain form which will be dealt with in detail later, together with a further statement explaining how the present position has been arrived at, called the Deficiency or Surplus Account.

The details may assume somewhat formidable proportions, but the principle involved is extremely simple, and once the elementary rules are thoroughly assimilated, no difficulty should be experienced in the working of examination problems on this subject. The procedure is as follows—

(1) A rough statement should be prepared with assets on the right-hand side and liabilities on the left, in ordinary Balance Sheet form.

(2) Each item must appear on the *same* side in the Statement of Affairs or Deficiency Account as it appears in the rough Balance Sheet.

The estimated value of each asset will appear on the right-hand side of the Statement of Affairs.

The estimated amount of each liability will appear on the left-hand side of the Statement of Affairs.

The estimated loss (the excess of book value over estimated realizable value of an asset, or the increase in the amount of liability over the book value) will appear on the right-hand side of the Deficiency Account.

The estimated gain (the excess of estimated realizable value over the book value of an asset, or the decrease in the amount of liability over the book value) will appear on the left-hand side of the Deficiency Account.

(3) Any item not in the rough balance sheet must appear both in the Statement of Affairs and in the Deficiency Account, but on reverse sides; in other words, there must be double entry therefor.

(4) The Capital Account must be accounted for in the Deficiency Account on the same side as it appears in the Balance Sheet. Certain adjustments are required in connection with the Capital Account, as will be noticed presently, but the rule herein will, nevertheless, be followed.

(5) The balance of the Statement of Affairs and Deficiency Account will be equal and closed by a cross transfer.

These rules may be summarized—

(1) Every item in the Balance Sheet must be accounted for directly or indirectly on the corresponding side of the Statement of Affairs or the Deficiency Account.

(2) Any item not in the Balance Sheet must directly or indirectly appear both in the Statement of Affairs on the one side and in the Deficiency Account on the opposite side.

It should be noted that there is a fixed layout in which bankruptcy accounts are presented, as shown in detail on page 1219. In the first few examples, the layout is, for convenience, only approximately adhered to, so that the principles may be fully explained.

Illustration. The following is the Balance Sheet of X Y as it appears on the 31st December, 19..—

BALANCE SHEET

	£		£
Sundry Creditors (*c*)	600	Sundry Debtors (*b*)	1,000
Loan (*c*)	55	Stock (*a*)	150
Capital (*d*)	495		
	£1,150		£1,150

The debtors are estimated to produce £325 and stock £180. The creditors and loan holders have no special rights.

Prepare in ***rough*** outline the Statement of Affairs and Deficiency Account for submission to the creditors.

STATEMENT OF AFFAIRS

	£		£
Unsecured Creditors (*c*)	655	Stock (*a*)	180
		Debtors (*b*)	325
			505
		Deficiency (*e*)	150
	£655		£655

DEFICIENCY ACCOUNT

		£			£
Capital . . . (d)		495	Bad Debts . . (b)		675
Appreciation of Stock (a)		30			
Deficiency as per Statement of Affairs . (e)		150			
		£675			£675

It will be observed that each item in the Balance Sheet is duly accounted for on its proper side, the only item likely to cause trouble being that of stock. The Balance Sheet shows the item of £150 on right-hand side, but being worth £180 the latter value must be shown in the Statement of Affairs on right-hand side, so that in order that the two statements will "balance" £30 will be shown on the LEFT-hand of the Deficiency Account. The balance on each of the accounts will be reflective and closed by a transfer (item marked "*e*"). The sides of the Statement of Affairs are similar to those of a Balance Sheet, whilst those of the Deficiency Account are opposite to those of a Profit and Loss Account, so that the left-hand side of the Deficiency Account is GAIN, and the right-hand side is LOSS.

Where, as is required by law, the capital at a date prior to the Statement of Affairs has to be ascertained, the intervening movement of capital must be traced, but, as already mentioned, the same principle applies, viz. that the capital balance in some form or other must appear on the same side of the Deficiency Account as it appears in the Balance Sheet from which the Statement of Affairs and the Deficiency Account are prepared.

Illustration. Assume the same facts as in the previous illustration, and in addition the question states that a year ago the debtor's capital was £2,100; his profits (less losses) being £400, and his drawings £2,005. Now it is clear that the left-hand item of £495 (present capital per Balance Sheet) must be accounted for, i.e. a net left hand of £495: hence it is necessary to key up the intervening figures, thus—

LEFT HAND	£	£	RIGHT HAND
Old Capital . .	2,100		
Add profits .	400		
		2,500	
Less Drawings .		2,005	
Net left-hand Balance . . .		£495	

All that requires to be done is to substitute the details above for £495, taking care that the latter item is not actually inserted in addition to the substituted figure. The above affects only the Deficiency Account, which therefore will be—

DEFICIENCY ACCOUNT

Capital . . . (*d*)	[1]	£ 2,100	*Drawings* . . (*d*)		£ 2,005
Profits . . . (*d*)		400	Bad Debts . . (*b*)		675
Appreciation of Stock (*a*)		30			
Deficiency as per Statement of Affairs . (*e*)		150			
		£2,680			£2,680

The items marked (*d*) (italicized) simply replace the single item "left hand" of £495.

The preparation of these accounts, although essentially the same in principle, is not quite so simple when—as almost invariably happens—there are different grades of creditors. For the moment it will suffice to say that, where a creditor holds property of the debtor as security, he is able to utilize it; and may claim against the estate of the bankrupt for the balance if the security falls short of the debt, but must surrender the surplus to the estate if the security exceeds the debt due. Certain other creditors have the right to be paid in priority to the ordinary or unsecured creditors. These creditors are known as preferential creditors. On page 1208 a full list is given and illustrated; but the principle of dealing with the unsecured and preferential creditors will first be shown.

Illustration. X, who has been adjudicated a bankrupt, shows the following assets and liabilities (put in Balance Sheet form). The figures in parenthesis on the assets side show the estimated realizable value of the respective assets.

X—BALANCE SHEET

	£		£	Estimated to produce £
Creditors . . .	2,300	Debtors (*h*) . . .	1,500	(1,200)
Bank Overdraft . .	520	Stock (*b*) . . .	430	(300)
Loan secured by Mortgage on Buildings .	1,000	Cash (*a*) . . .	25	(25)
Capital . . .	295	Buildings (*g*) . . .	1,560	(1,100)
		Goodwill (*c*) . . .	500	(Nil)
		Patent (*d*) . . .	100	(230)
	£4,115		£4,115	

Of the creditors, £360 are preferential; the bank has no security. The capital of X three years ago was £1,000, his losses for the last two years being £705, and the profit for the year prior thereto, £700. His drawings over the period of three years were £700.

Prepare Statement of Affairs and Deficiency Account.

The important points to observe are—

[1] The phrase used in the official form is: "Excess of assets over liabilities

(*a*) The capital (see previous illustration) will not appear as £295 in the Deficiency Account, but as follows—

	£		£
Capital	1,000	Losses	705
Profit	700	Drawings	700
	£1,700		£1,405

(*b*) The item of buildings £1,560 would, in the ordinary course, be shown as follows—

Statement of Affairs—right hand	.	£1,100 (estimated realizable worth)
Deficiency Account do.	.	460 (estimated loss on realization)

As, however, it is security, it is shown in the Statement of Affairs in a different form (but having the same effect on the balancing result) as a DEDUCTION from the left-hand item—LOAN on MORTGAGE.

(*c*) The preferential creditors are included in the £2,300, which is a left-hand item, and hence £2,300 must be accounted for as follows—

	£	£
Unsecured Creditors—		
Sundry Creditors	2,300	
Less Preferential Creditors . . .	360	
		1.940
Bank		520
		£2,460

The preferential creditors are shown in short (but not carried into the total column) on the left-hand, but as they have the first right to the free assets they are DEDUCTED from the estimated value of the free assets.

STATEMENT OF AFFAIRS

Liabilities		£	*Assets*	£
Unsecured Creditors (*e*) . .	£	2,460	Cash (*a*)	25
			Stock (*b*)	300
Loan (*f*) . .	1,000		Goodwill (*c*)	—
Less Buildings (*g*)	1,100		Patent (*d*)	230
			Debtors (*h*)	1,200
Surplus to *Contra*	£100[1]		Surplus per *Contra* . .	100[1]
				1,855
Preferential Creditors (*e*) deducted *Contra* . .	£ 360		*Deduct* Preferential Creditors (*e*) per *Contra* . .	360
				1,495
			Deficiency	965
	£	2,460	£	2,460

[1] See footnote on page 1205.

DEFICIENCY ACCOUNT

		£			£
Capital		1,000	Business Loss	(h)	705
Profits		700	Bad Debts	(b)	300
Appreciation of Patent		130	Depreciation of Stock	(g)	130
Deficiency as per Statement of Affairs		965	,, ,, Buildings	(c)	460[1]
			,, ,, Goodwill		500
			Drawings		700
	£	2,795		£	2,795

Sometimes, in addition to there being a first mortgage on property, there is a second mortgage. In this case, the surplus, if any, of the security available for the first mortgagee is not brought over to the free assets, but deducted from the loan of the second mortgagee.

The treatment is dealt with below, the whole of the illustration being concentrated on this particular point.

Illustration. From the following particulars prepare a Statement of Affairs and Deficiency Account.

	£	Estimated Value £
Unsecured Creditors	1,800	
Preferential Creditors	200	
Loan First Mortgage	1,000	
Loan Second Mortgage	300	
Sundry Assets	2,000	(1,010)
Buildings (Security for the Mortgagees)	1,500	(1,130)

The capital three years ago was £2,500, business losses being £1,400, gambling losses £60, drawings £840.

The rough Balance Sheet is as follows—

	£		£
Sundry Creditors	2,000	Sundry Assets	2,000
Loan Creditors:		Buildings	1,500
1st Mortgage	1,000		
2nd Mortgage	300		
Capital	200		
	£3,500		£3,500

[1] If reference be made to the Balance Sheet it will be seen that Buildings £1,560 right hand, and Loan £1,000 left hand = £560 net right hand. This is reflected in items [1]: i.e. £100 Surplus of Security over debt right hand, *plus* £460 in Deficiency Account (for loss of value on buildings) = £560 right hand.

(*e*) The Creditors in Balance Sheet left hand are reflected in the above £2,460 left hand and £360 right hand deduction = £2,820 (i.e. Creditors, £2,300 + Bank Overdraft, £520).

Statement of Affairs

		£		£
Unsecured Creditors . .		1,800	Sundry Assets	1,010
Fully Secured Creditor—	£		*Deduct* Preferential Creditors per *Contra* . .	200
First Mortgage . .	1,000			
Less Buildings .	1,130			810
Surplus, as below .	£130		Deficiency	1,160
Partly Secured Creditor—				
Second Mortgage .	300			
Less Surplus from Fully Secured Creditor[1] . .	130			
		170		
Preferential Creditors Deducted *Contra*	200			
		£1,970		£1,970

Deficiency Account

	£		£
Capital	2,500	*Business Losses* . .	1,400
Deficiency as per Statement of Affairs . .	1,160	Depreciation of Assets .	990
		" " Buildings	370
		Drawings . . .	840
		Gambling Losses . .	60
	£3,660		£3,660

The items in the Deficiency Account in italics represent the Capital item of £200 in the rough Balance Sheet on page 1205.

It will be obvious that not only the business position, but also the private position will have to be brought into account; but so long as the two capitals in the Deficiency Account are kept separate the problem presents no new difficulties.

Illustration. Y, as a result of being in financial difficulties, disclosed the following position in regard to his affairs, at the date of the Receiving Order.

[1] The item of £130, surplus from the security of the first mortgage, is *deducted* from the left-hand item of partly secured creditor. It can be seen that the loans in the Balance Sheet left hand are £1,300, and the security in the Balance Sheet right hand is £1,500.

These are reflected in the Statement of Affairs left hand.	£170
And Deficiency Account right hand	370
Net right hand .	£200

(*a*) *Business.*

BALANCE SHEET

	£		£	Estimated to Produce £
Creditors	1,600	Stock	200	40
Preferential Creditors	150	Debtors—		
Loan on Mortgage (secured		Good	810	810
on Property)	1,200	Doubtful	500	200
Bills Payable	600	Bad	600	Nil
Capital	620	Cash	10	10
		Property	1,800	1,700
		Bills Receivable	250	210
	£4,170		£4,170	

Three years ago his business capital was £1,000; profits and drawings during the period were, respectively, £1,100 and £1,480.

Contingent liability for bill discounted, £300 expected to rank for £80.

(*b*) *Private.*

BALANCE SHEET

	£		£	Estimated to Produce £
Capital	1,600	Furniture	600	500
		Life Policy	1,000	700
	£1,600		£1,600	

Prepare Statement of Affairs and Deficiency Account.

STATEMENT OF AFFAIRS

Liabilities		£	*Assets*		£
Unsecured Creditors		2,200	Cash		10
	£		Stock		40
Creditors fully secured	1,200		Furniture		500
Less Property	1,700		Life Policy		700
			Book Debts—		
Surplus to *Contra*	£500		Good		810
			Doubtful	£500	
Bills Discounted[1]	£300		Bad	600	
Estimated to rank		80		£1,100	
Preferential Creditors Deducted *Contra*	£150		Estimated to Produce		200
			Bills of Exchange		210
		2,280	Surplus per *Contra*		500
Surplus		540			
					2,970
			Deduct Preferential Creditors per *Contra*		150
		£2,820			£2,820

[1] See footnote on page 1208.

Deficiency Account

		£			£
Business—			Bad Debts . . .		900
Capital . . .	(a)	1,000	Depreciation of Stock .		160
Net Profit . .	(a)	1,100	,, ,, Property .		100
Private—			,, ,, Life Policy		300
Capital . . .		1,600	,, ,, Furniture.		100
			Loss on Bills Receivable .		40
			,, ,, Discounted[1]		80
			Drawings . . .	(a)	1,480
			Surplus as per Statement of Affairs . . .		540
		£3,700			£3,700

(a) £1,000 + £1,100 − £1,480 = £620, Capital per Business Balance Sheet.

The following are the classes of unsecured creditors—

Pre-Prefererential Debts

(*a*) If deceased, proper funeral and testamentary expenses.

(*b*) Money belonging to a Friendly Society or Trustee Savings Bank in possession of Bankrupt as its officer.

(*c*) Proper expenses incurred by a Trustee under Deed of Arrangement avoided by Bankruptcy of the Debtor.

(*d*) Apprenticeship premiums unexpired.

Preferential Creditors

(1) Assessed rates which have become due and payable within the twelve months *preceding* the Receiving Order.

(2) Assessed taxes up to the 5th April *preceding* the Receiving Order, not exceeding one year. [The Crown is not preferential in respect of debts arising in the course of trading.]

(3) Wages and salaries of a clerk or servant, workman or labourer for four months (not exceeding £200) accrued before Receiving Order, and accrued holiday remuneration.

(4) Where a labourer in husbandry has contracted for wages in a lump sum, the whole or a part of such sum, as the Court may decide to be due, proportionate to the time of service expired.

(5) Contributions under the National Insurance (Industrial Injuries) Act, 1946 or the National Insurance Act, 1946, payable during the twelve months prior to the date of the Receiving Order.

(6) Compensation under Reinstatement in Civil Employment Act, 1944, not exceeding £200.

(7) Purchase Tax, due in the twelve months prior to the Receiving Order, (Sect. 20, Finance Act, 1942).

(8) P.A.Y.E. deductions by an employer (less refunds to employees) arising during the twelve months prior to the Receiving Order (Sect. 30, Finance Act, 1952).

The mere fact of obtaining judgment or a garnishee order does not enable the creditor to rank preferentially.

[1] The item £80 must be introduced by "double entry."

In reference to assessed taxes, the Inland Revenue is preferential for one year prior to the making of the Receiving Order; thus, if a Receiving Order were made on 15th March, 1953, the liability for 1952–53 is *not* preferential as it has not arisen. The Revenue may select any year and is not limited to the last fiscal year ended before the Receiving Order. In regard to taxes, such as Profits Tax in the case of companies, assessed by reference to an accounting period and not to a fiscal year, the Revenue may select any one such period ended prior to the relevant date (see *In re Pratt*).

In addition, there is the right of the landlord to recover by distress rent outstanding in respect of the period, not exceeding six months, prior to ADJUDICATION (date debtor declared bankrupt).

Deferred Creditors. In bankruptcy the following are deferred—

(1) Money lent by a married woman to her husband for use in his trade or business as a sole trader or *otherwise*,[1] and money lent by a married man to his wife for use in her trade or business. Any loan made before marriage is not affected.

(2) Loans to a firm where the lender is to receive a share of profits or a rate of interest varying with profits; or money paid for goodwill in consideration for a share of profits.

(3) Beneficiaries claiming under a covenant made in consideration of marriage for the future payment of money, or to settle after-acquired property (where the covenant has become void against a Trustee in Bankruptcy).

(4) Interest on debts in excess of 5 per cent.

Deferred creditors do not become entitled to any dividend at all until the unsecured creditors have received payment in full; hence it is probably best to include them in a note on the Statement of Affairs so that, if they are of material amount, the balance available for the ordinary unsecured creditors is not abnormally reduced. If there is any surplus the deferred creditors will rank against it to the full extent of their debts before any return is made to the debtor.

Secured Creditors. A secured creditor is one holding a mortgage, charge, or lien on the property of the debtor or any part thereof, as security for any debt due to him from the debtor.

Such creditors are entitled to satisfy the debt owing to them fully or in part out of the property held by them before any distribution to the unsecured creditors. Where the security held is insufficient to discharge the whole debt, the secured creditor ranks as an unsecured creditor for the balance. Where the security is more than sufficient the surplus must be handed over to the estate.

Where the creditor holds security given by a *third* party, he is

[1] The words "or otherwise" are *ejusdem generis*; therefore if the loan by wife is to firm of which she is a partner, or where she lends money to her husband for purposes not connected with his trade, the above rule does not apply.

as regards the Bankrupt Estate UNSECURED, and after receipt of the final dividend will apply the security towards making up the balance of his debt.

Schedules. It must be observed that the items appearing in the Statement of Affairs are found from different schedules which are required by law to be extracted, just as the item "Sundry Debtors" in an ordinary Balance Sheet is found from a schedule of debtors drawn up for the purpose.

The schedules are—

A. Unsecured creditors.
B. Creditors fully secured.
C. Creditors partly secured.
D. Liabilities on bills discounted.
E. Contingent or other liabilities (including deferred debts).
F. Creditors for rent recoverable by distress.
G. Preferential creditors for rates, taxes, and wages.
H. Property.
I. Debts due to the estate.
J. Bills of exchange on hand.
K. Deficiency (or Surplus) Account.

A question of more advanced type is now presented.

Illustration. A Receiving Order was made against X on the 15th March, 1953. The following details were disclosed.

Creditors with security—

(1) Northern Bank, secured by hypothecation of stock valued at £15,000		£ 10,000	
(2) Loan on Mortgage, with Interest		8,000	
The Premises which are mortgaged valued at		11,000	(estimated to realize £9,200)
(3) Trade Creditors		4,000	
Holding Life Policy of X	2,000		
Holding Life Policy of Mrs. X	1,000		
Other Creditors: Unsecured		12,000	
Preferential: Income Tax, Sch. D.—			
1951–52, Arrears		700	
1952–53 (Loss)		nil	
1953–54		460	
Rates accrued due		400	
Wages, preferential		35	
Other Stock		2,200	
Book Debts—Good		3,000	
Doubtful and Bad		6,000	(estimated to realize £3,100)
Bills Receivable discounted		1,200	(expected to rank £200)

At 31st December, 1950, his capital was £12,605. Trading has

subsequently shown a loss of £8,000. Drawings (including a debit for income tax) £3,000. Except for book debts and premises, assets are estimated to realize book values. Prepare Statement of Affairs and Deficiency Account.

Before proceeding to prepare the Statement of Affairs it is essential to draft the rough Balance Sheets.

BUSINESS BALANCE SHEET

		£		£
Bank		10,000	Stock	15,000
Loan on Mortgage		8,000	,,	2,200
Trade Creditors		16,000	Book Debts	9,000
Expense Creditors—			Premises	11,000
Income Tax	£1,160			
Rates	400			
Wages	35			
		1,595		
Capital		1,605		
		£37,200		£37,200

PRIVATE BALANCE SHEET

	£		£
Capital	2,000	Life Policy	2,000

The creditors amounting to £35,595 require analysis, as follows—

CREDITORS	£	£
Fully Secured Creditors—Bank	10,000	
Mortgage	8,000	18,000
Partly Secured Creditors		4,000
Preferential Creditors—Rates	[1]400	
Wages	35	
Income Tax (1951–52)	[2]700	1,135
Unsecured Creditors		12,000
Non-provable Income Tax (because in 1953–54 Y is not carrying on business)		460
		£35,595

The item of £460 represents a gain and therefore is a "left-hand" item in the Deficiency Account; but as the question states that the drawings include income tax, the item will be deducted from the right-hand item of drawings, viz. £3,000 – £460 = £2,540.

It must now be noted that in the Statement of Affairs there is a further column for gross liabilities into which all liabilities, whatever the nature or quality, must be inserted. This additional column is only of a supplementary nature.

Its inclusion has been deferred until this illustration so as not to confuse the fundamental principle of construction.

[1] Had the item been rent it would not have been preferential, but recoverable by distress.

[2] Had this been 1952–53 the liability would not have been preferential.

K—Deficiency (or Surplus) Account

	£		£
Excess of Assets over Liabilities on the 31st Dec., 1950—		Net Loss arising from Business . . .	8,000
Business . . .	12,605	Bad Debts as per Schedule I . . .	2,900
Private . . .	2,000	Depreciation of Premises	1,800
Deficiency as per Statement of Affairs . .	835	Household and Personal Expenses . . .	2,540
		Loss on Bills Discounted	200
	£15,440		£15,440

The wife is a deferred creditor (see page 1209).
The Statement of Affairs appears on page 1213.

Illustration. The firm Hard and Upp file their petition and you are asked to draw up a Statement of Affairs and Deficiency Account as at 31st December, 1952, from the following information—

	£		£
Sundry Assets . . .	61,092	Estimated to produce. .	47,300
Unsecured Creditors . .	53,635		

The Capital Accounts (excluding their Current Accounts) at 31st December, 1952, are £10,000.

The drawings are £1,400 per annum (£800 for Hard and £600 for Upp).

Trading results are, after charging £500 per annum interest on Capital and £200 per annum for Partnership Salary (Upp)—

		£
1948 . . .	Profit . . .	1,300
1949 . . .	Profit . . .	400
1950 . . .	Loss . . .	1,600
1951 . . .	Profit . . .	200
1952 . . .	Loss . . .	3,000

On 1st January, 1948, Upp had introduced further cash of £2,000 duly credited to his Capital Account.

The Capital (composed of the fixed Capital of £10,000 *and* the balance of the current accounts) is £7,457 which will be made up of £10,000 Capital (Credit) and Current Accounts, (Debit) £2,543 (see page 1214).

The rough Balance Sheet is—

	£		£
Creditors	53,635	Sundry Assets . . .	61,092
Capitals	10,000	Current Accounts . .	2,543

The effective Capital is therefore £7,457 and this item is a left-hand item to be accounted for on the same side in the Deficiency Account as shown on page 1215 as follows—

Capital (1st Jan., 1952) .	(*a*)	Loss, year ended 31st Dec., 1952 .	(*b*)
		Personal Drawings, 31st Dec., 1952	(*c*)

STATEMENT OF AFFAIRS

Gross Liabilities	Liabilities		Expected to Rank	Assets		Estimated to Produce
£			£			£
12,000	Unsecured Creditors as per List (A) . . .		12,000	Stock as per List (H)		2,200
18,000	Creditors fully secured as per List (B)	£18,000		Book Debts as per List (I)—		
	Estimated Value of Securities . .	24,200		Good		3,000
				Doubtful	?	
	Surplus to *contra*	£6,200		Bad	?	
4,000	Creditors partly secured as per List (C)	£4,000			£6,000	
	Less Estimated Value of Securities	2,000				
			2,000	Estimated to Produce		3,100
1,200	Bills Receivable discounted as per List (D)	£1,200		Surplus from *contra*		6,200
	Expected to Rank.		200			14,500
1,135	Preferential Creditors per Lists (F) & (G)	£1,135		*Deduct* Preferential Creditors *per contra* .		1,135
	Deducted *Contra*					
						13,365
				Deficiency explained in Statement K . .		835
[1]£36,335			£14,200			£14,200

[1] £35,595 (as shown on page 1211) − £460 + £1,200

The Capital and Current Accounts as at 1st January, 1952, are—

	£	£	£	£	
Capital Accounts, 1st Jan., 1948 .				8,000	
Addition. 1948.				2,000	
Capital Accounts . . .				10,000	
Current Accounts, 1st Jan., 1948 .			3,657		
Less Loss, 1950	1,600				
Drawings 4 years, 31st Dec., 1951	5,600				
		7,200			
Deduct—					
Profit, 1948	1,300				
Profit, 1949	400				
Profit, 1951	200				
Interest on Capital for 4 years ended 31st Dec., 1951	2,000				
Partner's Salary for 4 years ended 31st December, 1951. .	800				
		4,700			
			2,500		
(as below)				1,157	
At 1st January, 1952 . . .				11,157	(*a*)
Less Loss, 1952		3,000			
Deduct Interest on Capitals for 1952 . . .	500				
Partner's Salary for 1952	200				
		700			
			2,300 *Dr.*		(*b*)
Less Drawings for 1952 . . .			1,400		
				Dr. 3,700	(*c*)
Capital and Current Accounts, 31st December, 1952				£7,457	

The composition of this total is—		£
Capital Accounts	*Cr.*	10,000
Current Accounts	*Dr.*	2,543
As above . . .		£7,457

[The combined Current Account need not be built up in detail, but it is given below for guidance.]

CURRENT ACCOUNT

	£			£
Drawings	1,400	1948	Opening	3,657
Closing	4,257		Salary and Interest .	700
			Profit . . .	1,300
Drawings	1,400	1949	Opening	4,257
Closing	3,957		Salary and Interest .	700
			Profit . . .	400
Loss	1,600	1950	Opening	3,957
Drawings	1,400		Salary and Interest .	700
Closing	1,657			
Drawings	1,400	1951	Opening	1,657
Closing	1,157		Salary and Interest .	700
			Profit . . .	200
		1952	Opening . . .	1,157

HARD AND UPP

Statement of Affairs, 31st December, 1952

Gross Liabilities		Expected to Rank		Estimated to Produce
£		£		£
53,635	Unsecured Creditors .	53,635	Sundry Assets	47,300
			Deficiency subject to Costs .	6,335
£53,635		£53,635		£53,635

Deficiency Account

	£		£
Excess of Assets over Liabilities at 1st January, 1952 . . . (a)	11,157	Loss for Year ended 31st December, 1952 . (b)	2,300
Deficiency per Statement of Affairs . . .	6,335	Personal Drawings . (c)	1,400
		Loss and Expenses—Sundry Assets . .	13,792
	£17,492		£17,492

The Current Account for 1952 is—

	£		£
Drawings . .	1,400	Opening	1,157
Loss	3,000	Salary and Interest .	700
		Closing	2,543
	£4,400		£4,400

Firm Bankruptcy. The position dealt with so far has been confined to a sole trader. Where, however, there is a firm bankruptcy the problems are a little more complicated. It should be remembered that Statements of Affairs will be required both for the firm and for its constituent members. Subject to certain exceptions, the private creditors have recourse only to the private estate, and the partnership creditors to the firm estate, generally referred to as the joint estate. Another confusing point arises where joint property is pledged as security for a private debt of one of the partners, in which case the private creditor is not a secured creditor, because he has not obtained the property of the debtor as security, but that of the joint estate. Examples are shown to illustrate the principles involved.

Illustration. A and B are partners and the position is as follows—

Balance Sheets
Firm

	£			£
Creditors	600	Stock.		300
		Debtors		100
		A	£120	
		B	80	
				200
	£600			£600

A

	£		£
Creditors	250	Furniture	300
Surplus	30	Sundry Assets . . .	100
Firm	120		
	£400		£400

B

	£		£
Creditors	900	Furniture	600
Firm	80	Life Policy	250
		Deficiency	130
	£980		£980

It is assumed that all assets are worth book value save that stock is estimated to realize £140. Prepare draft Statements of Affairs and Joint Deficiency Account.

STATEMENTS OF AFFAIRS

Joint

	£		£
Creditors	600	Stock	140
		Debtors	100
		Sundry Assets (A's Estate) .	150
			390
		Deficiency	210
	£600		£600

A

	£		£
Creditors	250	Furniture	300
Surplus	150	Sundry Assets . . .	100
	£400		£400

B

	£		£
Creditors	900	Furniture	600
		Life Policy	250
		Deficiency	50
	£900		£900

JOINT DEFICIENCY ACCOUNT

	£			£
A—Surplus	150	Excess of Liabilities over Assets of—		
Deficiency as per Statement of Affairs	210	A	£120	
		B	80	
				200
		Depreciation of Stock		160
	£360			£360

Each Statement of Affairs is separately compiled and each deficiency or surplus is separately ascertained. Any surplus introduced from a separate estate to the joint estate (not being in the original Balance Sheet of the firm) must have its double entry. It has already been stated that as regards creditors, each "set" proves against the particular debtor, i.e. separate against separate, joint against joint, but it should be observed that the surplus of A, i.e. £150, is now available for the joint creditors.

Where in a partnership a partner has given security for a firm debt, the joint estate has first claim on such security: any surplus goes to the separate estate of that partner, the reverse applying when joint property is given as security to separate creditors.

Illustration. The creditors are—

	£		£
Joint	3,000	Assets	1,600
A	500	,,	400
B	600	,,	640

The £640 asset of B has been placed as security for a loan of £500 to the firm included in the figure £3,000. The joint assets are estimated to realize £1,800. Prepare Statements of Affairs.

STATEMENTS OF AFFAIRS

JOINT

	£		£
Unsecured Creditors	3,000	Assets	1,800
		Deficiency	1,200
	£3,000		£3,000

A

	£		£
Creditors	500	Assets	400
		Deficiency	100
	£500		£500

B

	£		£
Creditors . . .	600	Surplus from Security held by Joint Creditors . .	440
		Deficiency	160
	£600		£600

The joint creditor of £500 would get (with the other joint creditors) 12s. in the £ dividend = £300, i.e. $\frac{18}{30} \times$ £500. Hence there is a shortage of £200. He recoups this from the £640 asset of B, leaving still a surplus of £440 which is now available for B's creditors.

This may be further proved as follows. The joint creditor has £640 security of B against the partnership debt £500, leaving £140 surplus. The dividend £300 received from the joint estate is now due to B's separate estate, since the £500 debt has been satisfied in full. B's estate thus receives £440 from the asset £640.

Statutory Forms. The two principal forms required by statute to be completed are here shown—

(1) Statement of Affairs in Bankruptcy.
(2) Statement K, Deficiency (or Surplus) Account.

These are set out on the following pages.

Trustee's Accounts and Remuneration. The Trustee in Bankruptcy must keep detailed accounts of his receipts and payments in the prescribed form of cash book. If the debtor's business is carried on, a Trading Account must be kept on a cash basis.

The Trustee's remuneration is fixed by the creditors or the Committee of Inspection, and must be by way of a percentage on realizations and a percentage on dividends to unsecured creditors, including preferential creditors and secured creditors to the extent that their security is insufficient so that they rank as unsecured for the balance.

THE BANKRUPTCY ACTS, 1914 AND 1926

STATEMENT OF AFFAIRS

In the High Court of Justice.
IN BANKRUPTCY. No. of 19..

RE...

TO THE DEBTOR.—You are required to fill up, carefully and accurately, this sheet, and such of the several sheets A, B, C, D, E, F, G, H, I, J, and K, as are applicable showing the state of your affairs on the day on which the Receiving Order was made against you, viz., the day of 19. . Such sheets, when filled up, will constitute your Statement of Affairs, and must be verified by oath or declaration.

Gross Liabilities. £ s. d.	Liabilities (as stated and estimated by Debtor).	Expected to Rank. £ s. d.	Assets (as stated and estimated by Debtor).	Estimated to Produce. £ s. d.
	Unsecured Creditors as per List (A)		Property as per list (H), viz.—	
	(£ s. d.) Creditors fully secured, as per list (B)		(*a*) Cash at Bankers . .	
	Estimated value of securities . . .		(*b*) Cash in hand . . .	
	Surplus		(*c*) Cash deposited with Solicitor for Costs of Petition	
	Less amount thereof carried to sheet (C)		(*d*) Stock-in-trade (cost £)	
	Balance thereof to *contra* . . .		(*e*) Machinery	
	Creditors partly secured, as per list (C) . .		(*f*) Trade fixtures, fittings, utensils, &c. . . .	
	Less estimated value of securities . .		(*g*) Farming stock . . .	
	Liabilities on Bills discounted other than Debtor's own acceptances for value, as per list (D), viz.—		(*h*) Growing crops and tenant right	
	On Accommodation Bills as Drawer, Acceptor, or Indorser . . . . .£		(*i*) Furniture	
	On other Bills as Drawer or Indorser . . . . .£		(*j*) Life policies . . .	
	£ : :		(*k*) Stocks and Shares . .	
	Of which it is expected will rank against the estate for dividend		(*l*) Reversionary and other interests under Wills .	
	Contingent or other Liabilities as per list (E) .£ : :		(*m*) Other property, viz.—	
	Of which it is expected will rank against the estate for dividend		Total as per list (H) . .	
	(£ s. d.) Creditors for rent, &c., recoverable by distress, as per list (F) .		Book Debts as per list (I), viz.— Good	
	Creditors for rates, taxes, wages, &c., payable in full, as per list (G) .		(£ s. d.) Doubtful . . Bad . . . £	
	Sheriff's charges payable under sec. 41 of the Act, estimated at .		Estimated to produce . .	
	Deducted *contra* .		Bills of Exchange or other similar securities on hand as per list (J) . . .£	
			Estimated to produce . .	
			Surplus from securities in the hands of Creditors fully secured (per *contra*) . . . . £	
			Deduct Creditors for distrainable rent, and for preferential rates, taxes, wages, sheriff's charges, &c. (per *contra*) . . £	
	[1] Surplus explained in Statement (K)		[1] Deficiency explained in Statement (K)	
£	£		£	

[1] Strike out words which do not apply.

LIST "K"—DEFICIENCY (OR SURPLUS) ACCOUNT

	£	s.	d.	£	s.	d.		£	s.	d.	£	s.	d.
Excess of Assets over Liabilities on the (1) _____day of_____19__ (if any)							Excess of Liabilities over Assets on the (1) _____day of_____19__ (if any)						
Net Profit (if any) arising from carrying on business from the (1)_____day of _____19__, to date of Receiving Order, after deducting usual Trade Expenses							Net loss (if any) arising from carrying on business from the (1)_____day of _____19__ to date of Receiving Order, after charging against Profits the usual Trade Expenses . . .						
Income or profit from other sources (if any) since the (1)_____day of _____19__							Bad Debts (if any) as per Schedule "I" (2)						
Gifts from relations and others . . .							Depreciation of stock-in-trade . .						
							,, ,, machinery . . .						
							,, ,, trade fixtures, fittings, &c.						
							Expenses incurred since the (1)_____ day of_____19__, other than usual Trade Expenses, viz., Household and personal Expenses of self and (3) .						
							(4) Other Losses and Expenses (if any)—						
							_____						
							_____						
							_____						
(5) Deficiency as per Statement of Affairs (if any)							(5) Surplus as per Statement of Affairs (if any)						
Total amount to be accounted for (6) £							Total amount accounted for . (6) £						

NOTES.—(1) This date should be **twelve months** before date of Receiving Order, *or* **such other time** as Official Receiver may have fixed.
(2) This Schedule must show when debts were contracted.
(3) Add "wife and children" (if any), stating number of latter.
(4) Here add particulars of other losses or expenses (if any), including liabilities (if any) for which no consideration received.
(5) Strike out words which do not apply.
(6) These figures should agree.

*Signature*________________

*Dated*________________19..

Lists "A," "B," etc., mentioned above contain the details of the figures set down in the Statement of Affairs and Deficiency Account.

Where any of the lists "A" to "J" are blank, list "L" will be substituted therefor, as below.

LIST "L"

(In substitution for such of the Sheets named "A—J," as will have to be returned blank.)

LIST.	PARTICULARS AS PER FRONT SHEET.	DEBTOR'S REMARKS.

CHAPTER XXXI

LIQUIDATION

LIQUIDATION is the term used to signify the process of winding up a company and thereby bringing to an end its corporate life. When a company is ordered by the Court to be wound up compulsorily, it is necessary to prepare a Statement of Affairs for submission to the creditors of the company.

The principles already outlined relative to bankruptcy, subject to certain modifications of detail, apply to limited companies in compulsory liquidation.

The main points of difference are—

(1) A limited company may have issued debentures giving a floating charge. Such a position is impossible in the case of an individual.

(2) The position in relation to shareholders (in liquidation called contributories), which cannot arise in the case of a private individual.

(3) The Deficiency Account contains a considerable amount of detail (whereas in bankruptcy such account merely contains the net loss or profit) and the period covered is three years prior to the winding-up order or as the Official Receiver directs, or from the formation of the company if the latter is within three years of the order; on the other hand, the Deficiency Account in bankruptcy commences at a date twelve months prior to the receiving order, unless the Official Receiver otherwise orders.

The forms now required vary in layout as compared with the old forms (and with those required in bankruptcy), but the principle of preparation is unchanged.

It should be noted that Preferential Creditors rank before Debentures with a floating charge.

The forms will include profits and losses of the period prior to the date of the Statement of Affairs (which will link up with the opening surplus or deficiency on Profit and Loss), and the gains or losses arising from estimated realizable values, and the liabilities as compared with the Balance Sheet figures forming the basis of the Statement of Affairs will be dealt with on the same principle (although differing in form) as in Bankruptcy.

The balance of estimated surplus or deficiency as regards unsecured creditors is automatically the difference between Gross Assets and Gross Liabilities, so that the Schedule of Gross Assets is a "memo" Schedule.

The following example illustrates the new layout referred to above.

Illustration. On 1st April, 1953, a compulsory order for winding up was made against Y, Ltd., the following particulars being disclosed—

	£	£	(Estimated to Produce) £
Cash in hand		5	5
Debtors		200	180
Land and Buildings		3,000	2,400
Fixtures		1,000	1,000
Unsecured Creditors	1,000		
Debentures—			
Fixed (secured on Land and Buildings)	2,100		
Floating	500		
Preferential Creditors	300		
Share Capital (£1 fully paid)	16,000		

Estimated liability for bills discounted £300, estimated to rank at £300. Contingent liabilities (*re* legal costs) £600, estimated to rank at £600.

The company was formed on the 1st October, 1951, and has made losses of £15,695.

Prepare Statement of Affairs and Deficiency Account.

The rough Balance Sheet is—

	£		£
Share Capital	16,000	Assets (as per question)	4,205
Creditors	3,900	Profit and Loss Account	15,695
	£19,900		£19,900

The items of £300 and £600 would appear as footnotes in the Balance Sheet of the company, and when brought into the statements will require "Double Entry."

The question of Debenture Interest has been ignored in this illustration, but the rule in reference thereto is that Debenture Interest is payable up to and including the date of repayment of the Debenture *in the case of a company which is* SOLVENT, otherwise interest ceases at the commencement of the liquidation.

[See Statement of Affairs on page 1223.]

The following example illustrates the position when shares are partly paid—

Illustration. BALANCE SHEET

	£		£
Share Capital (£1 each, 10s. called)	5,000	Sundry Assets	4,100
Calls in Advance	200	Calls in Arrear	300
Creditors	2,000	Profit and Loss Account	2,800
	£7,200		£7,200

Sundry Assets are estimated to produce £3,000.

STATEMENT as to the Affairs of Y Limited

on the 1st April, 1953, the date of the Winding-up Order, showing assets at estimated realizable values and liabilities expected to rank.

	(a) Estimated Realizable Values	(b) Due to Secured Creditors	(c) Deficiency Ranking as Unsecured	Surplus carried to last column	Estimated Realizable Values
	£	£	£	£	£
Assets not specifically pledged—					
Cash on Hand					5
Debtors					180
Fixtures					1,000
Assets Specifically Pledged—					
Freehold Property	2,400	2,100	—	300	
Estimated surplus from Assets specifically pledged					300
Estimated Total Assets available for Preferential Creditors, Debenture-holders secured by a Floating Charge, and Unsecured Creditors					1,485

Summary of Gross Assets

	£
Gross Realizable Value of Assets specifically charged	2,400
Other Assets	1,185
Gross Assets	£3,585

Gross Liabilities	Liabilities		
£			
2,100	Secured Creditors to extent to which claims are estimated to be covered by Assets specifically pledged (item (a) or (b) above, whichever is the less) [Insert in "Gross Liabilities" column only]		—
300	Preferential Creditors		300
	Estimated Balance of Assets available for Debenture-holders secured by a floating charge, and Unsecured Creditors		1,185
500	Debenture-holders secured by a floating charge		500
	Estimated Surplus as regards Debenture-holders		685
	Unsecured Creditors—	£	
1,000	Trade Accounts	1,000	
600	Contingent Liabilities (*re* legal costs)	600	
300	Contingent Liabilities (Bills discounted)	300	
			1,900
£4,800	Estimated Deficiency as regards Creditors being difference between—	£	
	Gross Assets	3,585	
	Gross Liabilities	4,800	
			1,215
	Issued and Called-up Capital: 16,000 shares of £1 each		16,000
	Estimated Deficiency as regards Members		£17,215

Deficiency or Surplus Account

	£
Items contributing to Deficiency or reducing Surplus—	
Net Trading losses (after charging items shown in note below)	15,695[1]
Estimated losses now written off	620
Other items contributing to Deficiency or reducing Surplus—	
Contingent Liabilities (*re* legal costs)	600
Contingent Liabilities (Bills discounted)	300
Deficiency as shown by Statement	£17,215

[1] Details in prescribed form are required to be shown separately.

[*Note*. As to Net Trading Profits and Losses (see form on page 1241).]

The calls are irrecoverable. The creditors include preferential creditors of £300. Prepare Statement of Affairs and Deficiency Account.

STATEMENT OF AFFAIRS ON ...., 19..

Gross Liabilities			Estimated Realizable Value
	Assets not specifically pledged—		£
	Sundry		3,000
	Unpaid Calls		nil
	SUMMARY OF GROSS ASSETS	£	
	Sundry	3,000	
	Gross Assets	£3,000	
	Estimated Total Assets available for Preferential Creditors, Debenture-holders secured by a floating charge and Unsecured Creditors		3,000
£	LIABILITIES		
300	Preferential Creditors		300
	Estimated balance of Assets available for Debenture-holders secured by a floating charge and unsecured creditors		2,700
1,700	Unsecured Creditors		1,700
	Estimated Surplus as regards Creditors—	£	
	Gross Assets	3,000	
£2,000	Gross Liabilities	2,000	
			1,000
	Issued and Called-up Capital— 10,000 Shares of £ each, 10s. called		5,000
	Estimated Deficiency as regards members		£4,000
	DEFICIENCY OR SURPLUS ACCOUNT		£
	Items contributing to Deficiency (or reducing Surplus)—		
	Trading Losses (to be shown in prescribed detail)		2,800
	Losses now written off		1,100
	Calls irrecoverable		300
	Items reducing Deficiency (or Contributing to Surplus)—		4,200
	Calls in Advance		200
	Deficiency as shown by Statement		£4,000

Preferential Creditors. The liquidator must, so far as he can, pay the preferential creditors. These are the same as in Bankruptcy (see page 1208), except that the date by reference to which priority is to be ascertained is that of the resolution to wind up if a voluntary liquidation, or, in the case of a compulsory winding up, the date of the appointment of the provisional liquidator if one is appointed, otherwise the date of the Court Order (*vide* Sect. 319, Companies Act, 1948).

(Exception: if the Compulsory Order is made where the company is *already* in process of being wound up voluntarily, the relevant date is the date of the resolution to wind up voluntarily.)

Liquidator's Final Account. In all liquidations a liquidator must prepare in statutory form a statement of his receipts and payments made up to the date of his application for release.[1]

The preparation of a Liquidator's Cash Account calls for no

[1] The student is referred to a legal work for fuller detail on this subject.

detailed explanation, but the following matters should be noted—

(1) There is no double entry required.

(2) The items should follow the order of the official form.

Preferential creditors are paid before debenture-holders with a floating charge, whilst debenture-holders with a fixed charge will receive payment out of the proceeds of their security, unless the latter is insufficient for that purpose, in which case the balance owing will rank as an unsecured liability (unless the charge is floating as well as fixed in which case the liability ranks after the preferential liabilities have been paid in full).

(3) The rights of various classes of shareholders (particularly if there is a surplus) require careful consideration. [See pages 988 and 1023 *et seq.*]

(4) The calculation of the remuneration.

(5) The form of cash book for liquidations differs from that required for bankruptcies.[1] The main outlines of the forms are given below, so that point (4) only requires further explanation.

As to (4) the remuneration is fixed by the Court in a compulsory, and by agreement in a voluntary winding up, usually upon a double basis, viz. as a percentage of receipts[2] by the liquidator and dividends to unsecured creditors.[3] There is little difficulty with the former, but the latter requires care because the liquidator (or trustee) obtains the sum upon the amount PAID, so that if there is insufficient to pay the creditors in full and the liquidator, both must suffer abatement.

Illustration. A liquidator has £11,220 to pay £20,000 creditors. After he has received his commission on collections, he is entitled to a further 2 per cent on dividends paid.

If he pays £100 he receives £2, thus absorbing £102. Hence he receives $\frac{2}{102}$ × £11,220 = £220, leaving £11,000 for distribution.

Illustration. The following are the balances of X, Ltd., which decides to wind up voluntarily on 1st January, 19. . .

BALANCE SHEET

	£		£	Estimated to Produce £
Share Capital (£1 fully paid)	2,000	Cash	60	
Creditors	4,900	Stock	1,700	1,680
(including £210 preferential)		Debtors	4,790	4,495
		Profit and Loss Account	350	
	£6,900		£6,900	

The liquidator's remuneration is to be 4 per cent on amounts

[1] A statement of the receipts and payments must be furnished by a trustee in bankruptcy.

[2] See footnote (²) on page 1226.

[3] These include preferential creditors, and also secured creditors to the extent that their security is insufficient to cover their claims so that they rank as unsecured for the balance.

collected and 2 per cent on dividends paid to unsecured creditors. Liquidation expenses are £40. Show Liquidator's Cash Account (calculate to nearest £).

Dr. LIQUIDATOR'S CASH ACCOUNT *Cr.*

Receipts	£	£	*Payments*	£	£
To Balance		60	By Law Costs	?	
,, Sale of Assets—			,, Auctioneer's Charges	?	
Stock	1,680		,, Incidental Expenses	?	40
,, Debtors	4,495		,, Liquidator's Remuneration—		
		6,175	4% on Amounts Collected[a]	247	
			2% on Dividends to Unsecured Creditors[1]	98	
					345
			,, Preferential Creditors		210
			,, Dividend of 20s. in £ to Unsecured Creditors		4,690
			,, Return to Contributories— 9s. 6d. in £ on 2,000 Shares of £1 each, fully paid		950
		£6,235			£6,235

Collection of Calls. Where shares are partly paid the liquidator will make a call in order to pay off liabilities as far as possible and to adjust the position between the contributories (i.e. shareholders) as between themselves.

Where practicable, a liquidator will attempt to avoid making a call greater than is really required, as otherwise there may be entailed a return to the contributories upon whom the call was made. If a call of 10s. will settle the list of contributories, it would involve a corresponding return to the contributories upon whom the call was made if the actual call was greater than 10s., e.g. if it were 12s. a return of 2s. would be required.

The same principles apply where more than two classes of contributories have to be dealt with.

Illustration. The cash remaining in the hands of the liquidator prior to making the return to contributories (before making calls) is £3,500. The issued share capital is 10,000 preference shares of £1 each fully paid (with priority as to capital), 10,000 ordinary shares of £1 each, 15s. paid, and 20,000 ordinary shares of £1 each, 10s. paid. Show Liquidator's Cash Account.

The loss suffered by the contributories is ascertained by taking the deficiency and dividing it by the issued share capital (on the assumption that the latter is FULLY PAID).

[1] See footnote on page 1227.

[a] Where there are mutual debts, e.g. A owes the Company £500 and is owed by it £100, the remuneration will be based on the "net" or set-off figure, i.e. £400, and not on the debt due to the Company, £500.

BALANCE SHEET

	£		£
Preference Shares . .	10,000	Cash	3,500
Ordinary Shares—		DEFICIENCY . . .	24,000
10,000 (15s. paid) . .	7,500		
20,000 (10s. paid) . .	10,000		
	£27,500		£27,500

Loss per ordinary share is therefore—

$$\frac{\text{Deficiency}}{\text{FULLY-PAID Ordinary Capital}} \text{ i.e. } \frac{24{,}000}{30{,}000} \times 20\text{s.} = 16\text{s. per ordinary share}$$

Dr. LIQUIDATOR'S CASH ACCOUNT *Cr.*

		£			£
	To Balance. . .	3,500		By Preference Shareholders . .	10,000
	,, Proceeds of Calls— Ordinary Shares:				
	10,000 at 1s. .	500			
	20,000 at 6s. .	6,000			
		£10,000			£10,000

In all the above instances no return was made to the ordinary shareholders, but if they have paid in previous calls more than their loss per share they will be entitled to a return, computed on the principles outlined.

If a contributory fails to pay his calls in full, whether by insolvency or otherwise, he is thereby debarred from participation in any return to contributories, until the other contributors have been paid sufficient to make all the shares the same amount paid up.

Where there is a third grade of share, e.g. Deferred Share, the rule already explained will be applied subject to these modifications—

(1) Ascertain if there is any of the deferred capital (however small) remaining. If the deficiency is *less* then the fully paid deferred capital, part of such capital remains. If so, the prior classes of shares will receive their capitals back as existing and the question of any

[1] Where there is insufficient cash left to pay the unsecured creditors in *full*, the calculation will be not 2 per cent thereof, but $\frac{2}{102}$, e.g. assuming the unsecured creditors to be £4,690 and after all obligations have been discharged (save that of the Liquidator's "Dividend" Remuneration of 2 per cent), there is a cash balance of £2,870 5s. 7d., the respective payments to the liquidator and unsecured creditors will be—

Liquidator . . $\frac{2}{102} \times$ £2,870·28 = £56 5s. 7d.
Unsecured creditors $\frac{100}{102} \times$ £2,870·28 = £2,814

The liquidator thus receives 2 per cent of £2,814.

Preferential creditors are "unsecured" for the purpose of calculating the liquidator's remuneration.

priority of repayment of capital as between themselves, e.g. preference shares and ordinary shares, does not arise; so that—

(*a*) Apply the previous rule for ascertaining the loss to be sustained (*deferred* share capital being substituted for *ordinary* share capital).

(*b*) Pay out cash to the preference and/or ordinary shares (i) in full if fully called and paid (ii) if not, to the extent called and paid.

(2) If such deferred capital is entirely exhausted—

(*a*) Make such calls as are required to make any such deferred capital fully paid.

(*b*) *Reduce* Deficiency by the amount of such fully called and paid Deferred Share Capital.

(*c*) Apply the rule previously outlined to ascertain the loss on the *Ordinary* Share Capital and proceed accordingly.

Illustration. The position in Balance Sheet form of Dick Hudson, Ltd. immediately prior to dealing with the repayment to members is—

	£		£
1,000 6% Preference Shares of £1 each, fully paid .	1,000	Cash at Bank . . .	4,650
2,000 Ordinary Shares of £1 each, fully paid . .	2,000	Deficiency	2,750
2,000 Ordinary Shares of £1 each, 15s. paid. . .	1,500		
3,000 Ordinary Shares of £1 each, 6s. paid . . .	900		
10,000 Deferred Shares of 2s. each, fully paid . .	1,000		
20,000 Deferred Shares of 2s. each, 1s. paid . . .	1,000		
	£7,400		£7,400

Preference have priority over ordinary; and ordinary have priority over deferred as regards repayment of capital.

Show Liquidator's Cash Account.

Ascertain the position of the Deferred Share Capital, e.g. whether or not *any* capital remains. On the basis of these being fully called and paid, the deficiency per share would be arrived at as follows—

$$\frac{2750 \text{ (Deficiency)}}{3000 \text{ (fully paid Deferred Capital)}} \times 24\text{d.} = 1\text{s. } 10\text{d.}$$

The prior Share Capitals are therefore intact and can be paid out per Balance Sheet: and the loss for the Deferred Shareholders is 1s. 10d. a share producing a repayment of 2d. per share to the fully paid Deferred shareholders and requiring the calling up of 10d. per share on the partly paid Deferred shareholders. (See top of next page.)

Illustration. Same facts as before except that cash is £3,000, and the deficiency £4,400, show Liquidator's Cash Account.

Dr. LIQUIDATOR'S CASH ACCOUNT *Cr.*

	£	s.	d.		£	s.	d.
To Balance . . .	4,650	0	0	By Repayment of Capitals			
" Proceeds of Call— 20,000 Deferred Shares at 10d. per share . . .	833	6	8	1,000 Preference (£1)	1,000	0	
				2,000 Ordinary (£1)	2,000	0	0
				2,000 Ordinary (15s.)	1,500	0	0
				3,000 Ordinary (6s.)	900	0	0
				10,000 Deferred (2d.)	83	6	8
	£5,483	6	8		£5,483	6	8

As the deficiency in the second illustration *exceeds* the FULLY-PAID Deferred Share Capital, all such Capital is lost: nevertheless the call of 1s. a share on the 20,000 Deferred Share Capital will be made *and* the deficiency corresponding with the fully paid Deferred Share Capital will be reduced. For the sake of clarity the position arising as a result of these operations is shown—

	£		£
Capital (excluding deferred) [first four in Balance Sheet on page 1228] . . .	5,400	Cash at Bank [£3,000 + £1,000] . .	4,000
		Deficiency [£4,400 – £3,000] .	1,400
	£5,400		£5,400

The Deferred Share Capital being lost, the loss per ordinary shareholder is required. This is—

$$\frac{1,400 \text{ (Deficiency)}}{7,000 \text{ (Fully paid ordinary capital)}} \times 20s. = 4s. \text{ a share.}$$

Dr. LIQUIDATOR'S CASH ACCOUNT *Cr*

	£		£
To Balance	3,000	By Repayment of Capitals—	
" Proceeds of Call— 20,000 Deferred Shares at 1s. per Share . .	1,000	1,000 Preference (£1) .	1,000
		2,000 Ordinary (16s.)[1] .	1,600
		2,000 Ordinary (11s.)[1] .	1,100
		3,000 Ordinary (2s.)[1] .	300
	£4,000		£4,000

Where there are no arrears of a call made by a Liquidator the problem of the treatment of a defaulting shareholder will not arise, because, where the loss is equivalent to the same amount per share as the uncalled portion, there will be a repayment *equal* to the called up amount of the fully paid shares; thus, if there are 2,000 shares of £1 each, fully paid, and 1,000 shares of £1 each, 14s. paid, and the deficiency is 14s. per share, the former will receive repayment of 6s. per share and the latter nothing.

Should the deficiency mentioned above be a *lesser* figure, even the partly called and paid share will obtain a repayment; thus, if the deficiency is 12s. per share there will be a repayment of 8s. per share

[1] As the loss per Ordinary Share is 4s., the repayments to the ordinary shareholders will be the amount paid, *less* 4s. per share, viz. 16s., 11s., and 2s. for the fully paid, 15s. paid and 6s. paid respectively.

and 2s. per share respectively for the fully paid and partly paid shareholders.

Should the deficiency be a *greater* figure a call will be made to cover the deficiency, and as a result there would be no repayment to the partly called and paid shareholders; thus, if the deficiency per share is 19s. there will be a repayment of 1s. to the fully paid shareholders and a call of 5s. upon the partly called and paid shareholders to bring their loss of 14s. per share to 19s.

Illustration. The liquidator has in hand £5,725 after payment of all costs and creditors, but before collecting from the deferred shareholders 1s. per share on their 10,000 shares of 2s. (1s. previously called and paid).

The ordinary share capital is—

4,000 Shares of £1 each fully paid.

5,000 Shares of £1 each 15s. called and paid (except arrears of a previous call of 2s. 6d. per Share on 1,000 Shares).

1,000 Shares of £1 each, 2s. called and paid.

The loss per Ordinary Share is 3s., so that the fully paid ordinary shareholders are entitled to a repayment of 17s. per share, the 15s. called *and paid* to 12s. per share; but the ordinary shareholders who have paid 2s. per share only must pay in 1s. per share (to bring their loss to 3s. per share).

Dr. LIQUIDATOR'S CASH ACCOUNT *Cr.*

Dr.	£	Cr.	£
To Balance of Proceeds . .	5,725	By Repayment of Capitals—	
,, Deferred Shares—		4,000 Ordny. Shares, 17s.	3,400
Call of 1s. per Share on		4,000 Ordny. Shares, 12s.	2,400
10,000 Shares . .	500	1,000 Ordny. Shares 9s. 6d.	475
,, Ordinary Shares—		[i.e. 12s. *less* Call unpaid 2s. 6d.]	
Call of 1s. per Share on			
1,000 Shares . .	50		
	£6,275		£6,275

The deficiency of 3s. is arrived at as follows—

	£		£
Share Capital—		Cash	5,725
Ordinary £1 (4,000) .	4,000	Deficiency	2,500
Ordinary 15s. (4,000) .	3,000		
Ordinary 12s. 6d. (1,000)	625[1]		
Ordinary 2s. (1,000) .	100		
Deferred 1s. (10,000) .	500		
	£8,225		£8,225

When the call on the deferred is received, the Cash is £6,225 and the Share Capital £8,725; but as the Deferred Capital (now £1,000) is entirely lost, this is eliminated and the deficiency reduced to £1,500, so that the loss to the ordinary shareholders is—

$$\frac{1{,}500 \text{ (Deficiency)}}{10{,}000 \text{ (fully-paid Ordinary Capital)}} \times 20\text{s.} = 3\text{s. per Ordinary Share}$$

	£
[1] 1,000 at 15s. called.	750
Less Call in arrear	125
	£625

Illustration. X, Ltd., is in liquidation, and after payment of all expenses and creditors in full there remains a surplus of £3,850 excluding calls in arrears.

The issued share capital is—

2,000 Preference Shares of £1 each fully paid, having priority over Ordinary and Deferred Shares.

5,000 Ordinary Shares of £1 each, fully paid } having priority over
5,000 Ordinary Shares of £1 each, 15s. paid } Deferred Shares

2,000 Deferred Shares of £1 each, 12s. paid.

A contributory holding 1,000 ordinary shares, 15s. called, failed to contribute further to the assets of the company to the extent of his unpaid call of 2s. a share. Show Liquidator's Cash Account.

Dr. LIQUIDATOR'S CASH ACCOUNT *Cr.*

		£			£
	To Balance (details on lines of previous illustrations)	3,850		By Preference Shareholders	2,000
	" Proceeds of Calls— Deferred Shares: 2,000 at 8s.	800		" Ordinary Shareholders 5,000 at 8s.	2,000
				4,000 at 3s.	600
				1,000 at 1s.[1]	50
		£4,650			£4,650

The loss per share is 12s. arrived at as follows—

		£			£
	Preference Share Capital	2,000		Cash	3,850
	Ordinary Share Capital	8,750		Call in Arrear	100
				Call due from Deferred	800
				Deficiency	6,000
		£10,750			£10.750

$$\therefore \text{ Loss} = \frac{6,000}{10,000} \times 20\text{s.} = \underline{\underline{12\text{s.}}}$$

Calls in Advance. Where calls have been paid in advance the amounts receivable from contributories will be correspondingly less; and when the loss per share is ascertained the amount so paid in advance must first be returned in addition to that receivable in common with the remaining contributories.

Illustration. The position of Z, Ltd., in liquidation, in Balance Sheet form, before the adjustment for contributories is—

BALANCE SHEET

	£		£
Share Capital issued—		Cash	1,260
1,000 £1, fully paid	1,000	DEFICIENCY	400
1,000 £1, 12s. paid	600		
Calls in advance—			
400 at 3s.	60		
	£1,660		£1,660

[1] 1,000 shares at 3s.—2s. call in arrears.

Show the Liquidator's Cash Account.

Each contributory loses 4s. a share, i.e. $\frac{400}{2,000} \times 20s.$

Dr. LIQUIDATOR'S CASH ACCOUNT *Cr.*

			£				£
	To Balance . . .		1,260		By Repayment of Calls in advance— 400 at 3s. .		60
					,, Shareholders— 1,000 at 16s. .		800
					1,000 at 8s. .		400
			£1,260				£1,260

Illustration. On 30th June, 19.., the liquidator of X, Ltd., having a share capital issued of 5,000 preference shares of £1 each fully paid *without* priority as to capital, 8,000 ordinary shares of £1 each, 18s. paid, and 12,000 ordinary shares of £1 each, 15s. paid, had a cash balance £1,645.

A dividend to the unsecured creditors of 12s. 6d. in the £ had already been paid as well as the amount due to the preferential creditor.

By 31st December, 19.., he had realized the remaining assets, amounting to £3,100, of which £2,000 was in respect of secured creditors of £1,400. All the costs of liquidation were £270.

The creditors, other than the *secured* creditors, were—

	£
Trade Creditors	4,740
Gas Board for Gas supplied	14
Salary of Clerk for six months	138
Directors' Fees for four months	200

Prepare Liquidator's Final Receipts and Payments Account.

Dr. LIQUIDATOR'S RECEIPTS AND PAYMENTS ACCOUNT *Cr.*

			£				£
	To Balance . . .	b/d	1,645		By Secured Creditors .		1,400
	,, Realization of Assets: General . . .		1,100		,, Liquidation Costs .		270
	Re Secured Creditors		2,000		,, Dividend of 7s. 6d. in £ to the Unsecured Creditors— 7s. 6d. in £ on £5,000[1].		1,875
					,, Balance . . .	c/d	1,200
			£4,745				£4,745
	To Balance . . .	b/d	1,200		By Preference Shareholders— 5,000 at 4s. .		1,000
	,, Proceeds of Calls— Ordinary Shares 12,000 at 1s. . .		600		,, Ordinary Shareholders— 8,000 at 2s. .		800
			£1,800				£1,800

[1] See footnote on page 1233.

The loss per share is 16s., computed as follows—

$$\frac{\text{Deficiency}}{\text{FULLY-PAID Share Capital}} \quad (a)\ \frac{20{,}000}{25{,}000} \times 20s. = 16s.$$

(*a*) This is shown by preparing rough Balance Sheet, thus—

(*Rough*) BALANCE SHEET

	£		£
Share Capital issued—		Cash (after payment of Costs and Creditors) .	1,200
5,000 Preference £1, fully paid . . .	5,000	DEFICIENCY . . .	20,000
8,000 Ordinary £1, 18s. paid . . .	7,200		
12,000 Ordinary £1, 15s. paid . . .	9,000		
	£21,200		£21,200

Receiver for Debenture-holders. A Receiver is an independent person appointed by the Court or an individual or group of individuals, to take possession of certain property for protective purposes, or receive income and profits therefrom and apply them as required.

Most appointments arise by order of Court, e.g. Receiver *pendente lite*, but a mortgagee has power to appoint a Receiver without the intervention of the Court, under the Law of Property Act, 1925, Sects. 101 and 109 (subject to certain exceptions).

A Receiver for Debenture-holders may be appointed if the Debentures confer that power on the Debenture-holders when their power of sale arises, as defined in the Debenture. If no such power is contained in Debentures, application must be made to the Court for the appointment of a Receiver.

In the case of Receiver appointed by the Court, accounts will be made up in such form and at such times as the Court may direct.

In regard to a Receiver for Debenture-holders, he may be given power to carry on the business of the company in respect of whose Debentures he has been appointed, in which case he is called Receiver and Manager.

Under the Companies Act, 1948 (Sects. 366 and 367), neither a body corporate nor an undischarged bankrupt can act as Receiver or Manager. Where a receiver or manager is appointed in respect

[1] The unsecured creditors are—

	£
Trade Creditors	4,740
Gas Board	14
Balance of Salary to Clerk*	46
Directors' Fees	200
	£5,000

* The Clerk is entitled to be regarded as a preferential creditor for four months (not exceeding £200 = $\frac{2}{3}$ × £138 = £92, hence the balance of £46 ranks as unsecured.

of the whole or substantially the whole of the property of an English company on behalf of holders of debentures secured by a floating charge, then—

(*a*) The Receiver must forthwith send notice to the *company* of his appointment.[1]

(*b*) There shall within fourteen days of the notice (or extended time if allowed by the Receiver or Court) be made out and submitted to the Receiver a statement in prescribed form as to the affairs of the Company; and

(*c*) The Receiver must within two months after receipt of such statement send a copy of the statement to the Court and the Registrar of Companies and also a summary of the statement to the latter (accompanied in both cases by such comments as he thinks fit); to the company a copy of such comments or if he makes none, a notice to that affect, and to any Trustees for Debenture-holders on whose behalf he was appointed and to all Debenture-holders a copy of such summary (Sect. 372).

The Receiver must forward an abstract in the prescribed form of his Receipts and Payments within two months after the expiration of twelve months from the date of his appointment, every subsequent twelve months and on ceasing to act, to

(*a*) Registrar of Companies.
(*b*) Trustees for Debenture-holders.
(*c*) All Debenture-holders, (so far as he is aware of their addresses).
(*d*) The Company (Sect. 372 (2)).

The abstract must show, in the case of the yearly return, the receipts and payments for the said period of twelve months; in that on ceasing to act, the receipts and payments from the end of the last twelve-month period to the date of his ceasing to act, *and* the aggregate amounts of his receipts and payments during all preceding periods since his appointment.

The Court may extend the period of two months for delivery of the abstract (Sect. 372).

Such duty of the Receiver to render proper accounts includes the vouching of such accounts.

The statement required to be submitted to the Receiver must—

(*a*) Show details of assets, debts and liabilities of the company.

(*b*) Show names, residences and occupations of its creditors, securities given, the dates securities given and such other information as may be prescribed.

(*c*) Be verified by affidavit of one or more directors and the secretary of the company at the date of the Receiver's appointment, or past or present officers of the company, or those taking

[1] Under the Companies Act, 1948, Sect. 102, the person making or obtaining (from the Court) the appointment must notify the Registrar of Companies within seven days of the appointment.

part in the formation of the company within *one* year before the date of the Receiver's appointment, or past or present employees of the company within the said year capable (in the opinion of the Receiver) of giving the information required, or present officers or employees (or those who have been within the said year) of a *company* which is (or within the said twelve months was) an officer of the company to which the statement relates (Sect. 373).

A Receiver appointed out of Court may apply to the Court for directions.

A Receiver appointed out of Court is personally liable on contracts entered into with him unless the contract otherwise provides, subject to the right of indemnity. The Court has power to fix the remuneration of a Receiver appointed out of Court, (Sect. 371) bringing the position [in the above respect] of the Receiver appointed under an instrument in line with that of a Receiver appointed by the Court.

If the proceeds of sale of the property comprised in the charge in favour of Debenture-holders with a *floating* charge are insufficient to meet fully the claims of such Debenture-holders, the sums available are to be applied in the following order—

(1) Cost of realization.

(2) Other costs, including the remuneration of the Receiver.

(3) Costs and expenses of the Debenture Trust Deed (including the remuneration of the Trustees under the Deed if the Trust Deed provides that such remuneration be a first charge on the amounts realized from the debenture-holders' security).

(4) Plaintiff's costs of action.

(5) Preferential creditors.[1]

(6) Debenture-holders.

(*re Glyncorrwg Colliery Company*.)

General Illustration. On page 1236 is the Balance Sheet (abridged) of Y, Ltd., at 31st December, 1952.

The mortgage was secured on the real property and the debentures were secured by a floating charge on the assets of the company.

The company being in a precarious condition, a receiver was appointed by the debenture-holders: a liquidator was also appointed. The mortgagees realized their security for £4,000.

The receiver seized certain of the assets amounting to £37,000 and sold them for £34,000. The bank had the guarantees of the directors totalling £2,000, in addition to their life policies amounting to £300. The directors duly honoured their obligation to the bank. The balance of the assets realized five-sixths of their book value. The respective costs and remuneration of the receiver and liquidator were £600 and £400. The preference shareholders were entitled to be repaid 20s. in the £ in priority to ordinary shareholders.

Prepare Receipts and Payments Account of the receiver and liquidator.

[1] The date by reference to which priority is to be ascertained is the date of the appointment.

Balance Sheet

		£		£
Issued Share Capital—			Sundry Assets . . .	52,900
10,000 Preference Shares of £1 each, fully paid . . .		10,000	Preliminary Expenses .	1,000
10,000 Ordinary Shares of £1 each, fully paid .	£10,000		Profit and Loss Account .	3,350
5,000 Ordinary Shares of £1 each, 17s. paid .	4,250	14,250	Real Property . . .	5,000
6% Debentures . . .		25,000		
Loan on Mortgage . .		3,000		
Bank (No. 1) Account. . *Cr.*	£4,500			
Less Bank (No. 2) Account . *Dr.*	2,000	2,500		
Trade Creditors . .		5,500		
Commissioners of Inland Revenue—				
1950–51 .	£1,500			
1951–52 .	500	2,000		
		£62,250		£62,250

Dr. Receiver's Receipts and Payments Account *Cr.*

		£			£
To Sale of Assets (specified) . .		34,000	By Costs .£ ? ,, Remuneration ?		600
,, Surplus from Mortgages[1] . .		1,000	,, Preferential Creditors—Income Tax 1950–51 . .		1,500
			,, Debenture Holders		25,000
			,, Balance to Liquidator . . .		7,900
		£35,000			£35,000

Dr. Liquidator's Receipts and Payments Account *Cr.*

		£			£
To Receiver . .		7,900	By Costs . .£ ? ,, Remuneration ?		400
,, Sundry Assets .		13,250	,, Unsecured Creditors in full (as per Schedule) .		8,500
			,, Preference Shareholders . .		10,000
			,, Balance . .	c/d	2,250
		£21,150			£21,150
To Balance. . .	b/d	2,250	By Ordinary Shareholders— 10,000 at 4s. .		2,000
			5,000 at 1s. . [4s.—3s.] .		250
		£2,250			£2,250

[1] It is not stated whether this is "net," after deduction of realization expenses. The proceeds should be entered "gross" and the costs thereof entered as payments.

Schedule of Unsecured Creditors

	£
Commissioners of Inland Revenue—	
Income Tax, 1951–52 (subject to adjustment) .	500
Bank £2,500, *less* Guarantees and Life Policies £2,300	200
Directors	2,300
Trade Creditors	5,500
	£8,500

The loss on each share is 16s. calculated in the ordinary way.

[*Note*.] If there is a balance remaining on hand, it must be paid to the Companies Liquidation Account at the Bank of England before dissolution of the company.

Settling the List of Contributories. *Contributions by "B" Contributories.* The liquidator may call upon the "B" contributories (in case of default by the "A" contributories) to pay in money to meet the debts and costs in respect of debts existing at the date they ceased to be members. The "B" contributories are those contributories who have ceased to be members within one year from the date of the commencement of the liquidation, the "A" contributories being the present members.

Illustration. In a liquidation which commenced on 1st February, 1953, the unsecured creditors were £13,000.

The following are the material details of the contributories appearing on the "B" list—

	No. of Shares	Date of Ceasing to be Member	Creditors Outstanding at Date of Ceasing to be Member
			£
A	1,000	1st August, 1952	500
B	1,500	1st September, 1952	750
C	300	1st October, 1952	800
D	200	15th December, 1952	950

The above creditors had received no payment at the date of the liquidation.

The shares are of £1 each, 12s. paid.

Assuming that the contributories on the "A" list completely default, and that the liquidator realizes a further £1,148 6s. 8d., show the amount of the dividend to the unsecured creditors. Ignore expenses, costs, and remuneration of the liquidator.

The "B" contributories duly fulfil their obligations.

[This illustration is continued on page 1240.]

STATEMENT as to the affairs of . . ..

on the .... 19——, the and liabilities expected to rank.

	Estimated Realizable Values £
ASSETS NOT SPECIFICALLY PLEDGED (as per List "A")	
Balance at Bank	
Cash in hand	
Marketable Securities	
Bills Receivable	
Trade Debtors	
Loans and Advances	
Unpaid Calls	
Stock-in-Trade	
Work in Progress	
Freehold Property	
Leasehold Property	
Plant and Machinery	
Furniture, Fittings, Utensils, etc.	
Patents, Trade Marks, etc.	
Investments other than marketable securities	
Other property, viz.—	

ASSETS SPECIFICALLY PLEDGED (as per List "B")	(a) Estimated Realizable Values	(b) Due to Secured Creditors	(c) Deficiency Ranking as Un-secured (see next page)	Surplus carried to last column
	£	£	£	£
Freehold Property				
..				
	£	£	£	£

Estimated surplus from Assets specifically pledged	
ESTIMATED TOTAL ASSETS AVAILABLE FOR PREFERENTIAL CREDITORS, DEBENTURE-HOLDERS SECURED BY A FLOATING CHARGE, AND UNSECURED CREDITORS* (carried forward to next page)	£

SUMMARY OF GROSS ASSETS

	(d) £
Gross realizable value of assets specifically pledged	
Other Assets	
GROSS ASSETS	£

Limited

date $\frac{\text{of the Winding-up Order}}{\text{directed by the Official Receiver}}$ showing assets at estimated realizable values

		£
	ESTIMATED TOTAL ASSETS AVAILABLE FOR PREFERENTIAL CREDITORS, DEBENTURE-HOLDERS SECURED BY A FLOATING CHARGE, AND UNSECURED CREDITORS* (brought forward from preceding page)	
(e) Gross Liabilities	LIABILITIES (to be deducted from surplus or added to deficiency, as the case may be)	
	SECURED CREDITORS (as per List "B") to extent to which claims are estimated to be covered by Assets specifically pledged (item (a) or (b) on preceding page, whichever is the less) [Insert in "Gross Liabilities" column only.]	
	PREFERENTIAL CREDITORS (as per List "C")	
	ESTIMATED BALANCE of assets available for Debenture-holders secured by a floating charge, and Unsecured Creditors* . £	
	DEBENTURE-HOLDERS secured by a floating charge (as per List "D")	
	ESTIMATED SURPLUS/DEFICIENCY as regards Debenture-holders* £	
	UNSECURED CREDITORS (as per List "E")— £	
	Estimated unsecured balance of claims of Creditors partly secured on specific assets, brought from preceding page (c)	
	Trade Accounts	
	Bills Payable	
	Outstanding Expenses	
	. . . . .	
	. . . . .	
	Contingent Liabilities (state nature)—	
	. . . . .	
	. . . . .	
	ESTIMATED SURPLUS/DEFICIENCY AS REGARDS CREDITORS* being difference between: GROSS ASSETS brought from preceding page (d) and GROSS LIABILITIES as per column (e) . . £	
£		
	ISSUED AND CALLED-UP CAPITAL £	
	.. preference shares of each called-up (as per List "F") . . .	
	ordinary shares of each called-up (as per List "G") . . .	
	ESTIMATED SURPLUS/DEFICIENCY AS REGARDS MEMBERS* (as per List "H") . . . . £	

* These figures must be read subject to the following notes—

(1) (f) There is no unpaid capital liable to be called up *or*

(g) The nominal amount of unpaid capital liable to be called up is £ estimated to produce £ which is/is not charged in favour of Debenture-holders.

Strike out (f) or (g)

(2) The estimates are subject to costs of the winding-up and to any surplus or deficiency on trading pending realization of the Assets.

STATEMENT OF LIABILITY OF "B" CONTRIBUTORIES

Creditors Outstanding		A Shares	A £ s. d.	B Shares	B £ s. d.	C Shares	C £ s. d.	D Shares	D £ s. d.	Cash £ s. d.
	£	1,000		1,500		300		200		
(1) . .	500	(a)	166 13 4		250 0 0		50 0 0		33 6 8	500 0 0
(2) . .	250				187 10 0		37 10 0		25 0 0	250 0 0
(3) . .	50						30 0 0		20 0 0	50 0 0
(4) . .	150	(b)							1 13 4	1 13 4
Total .	£950								£	801 13 4

Notes. (*a*) The liability in each case is in proportion to the shareholding as at the date of ceasing to be members in respect of debts outstanding on that date, e.g. in (*a*) the liability of each "B" contributory is $\frac{10}{30}$; $\frac{15}{30}$; $\frac{3}{30}$; and $\frac{2}{30}$ of £500.

(*b*) Although the amount required to be contributed solely by D appears to be £150 (the others not being liable because they were not members at the 15th December, 1952, the date of the extra £150 outstanding) yet the sum claimable from him is £1 13s. 4d., inasmuch as his maximum liability to the company is £80, being 8s. in £ on 200 shares; and having already contributed £78 6s. 8d. [items 1, 2, and 3] he can be called upon to pay only £1 13s. 4d.

It may be noted that C's maximum liability is 8s. in £ on 300 shares, viz. £120, so that whatever be the amount of the creditors in item 3, the liquidator could have claimed from C only £32 10s., i.e. £120 less already contributed £87 10s. [items 1 and 2].

The cash received into the *general* funds of the company is £801 13s. 4d., which together with £1,148 6s. 8d. makes £1,950 available for unsecured creditors of £13,000, i.e. 3s. in £.

Statutory Forms. The most important statutory forms in liquidation are—

(1) Statement of Affairs and Deficiency Account in Compulsory Liquidation.

(2) Declaration of Solvency embodying a Statement of Assets and Liabilities in a Member's Voluntary Winding-up. (See Sect. 283 Companies Act, 1948.)

(3) Statement of Liquidator's Receipts and Payments.

(4) Liquidator's Statement of Accounts (when the property of of the company has been disposed of).

Forms (1) and (2) are reproduced on pages 1238–9 and 1241–3.

List H'—Deficiency or Surplus Account

The period covered by this Account must commence on a date not less than three years before the date of the winding up order (or the date directed by the Official Receiver) or, if the company has not been incorporated for the whole of that period, the date of formation of the company, unless the Official Receiver otherwise agrees

Items Contributing to Deficiency (or Reducing Surplus) £

1 Excess (if any) of Capital and Liabilities over Assets on the 19 as shown by Balance Sheet (copy annexed)
2 Net dividends and bonuses declared during the period from 19 to the date of the Statement
3 Net trading losses (after charging items shown in note below) for the same period
4 Losses other than trading losses written off or for which provision has been made in the books during the same period (give particulars or annex schedule)
5 Estimated losses now written off or for which provision has been made for the purpose of preparing the Statement (give particulars or annex schedule)
6 Other items contributing to Deficiency or reducing Surplus

Items Reducing Deficiency (or Contributing to Surplus) £

7 Excess (if any) of Assets over Capital and Liabilities on the 19 as shown on the Balance Sheet (copy annexed)
8 Net trading profits (after charging items shown in note below) for the period from the 19 to the date of the Statement
9 Profits and income other than trading profits during the same period (give particulars or annex schedule)
10 Other items reducing Deficiency or contributing to Surplus

Deficiency/Surplus as shown by Statement £

Note as to Net Trading Profits and Losses

Particulars are to be inserted here (so far as applicable) of the items mentioned below which are to be taken into account in arriving at the amount of net trading profits or losses shown in this Account— £

Provisions for depreciation, renewals or diminution in value of fixed assets
Charges for United Kingdom income tax and other United Kingdom taxation on profits
Interest on debentures and other fixed loans
Payments to directors made by the company and required by law to be disclosed in the accounts
Exceptional or non recurring expenditure—

Less Exceptional or non recurring receipts— £

Balance, being other trading profits or losses £

Net trading profits or losses as shown Deficiency or Surplus Account above £

Signature Dated 19

DECLARATION OF SOLVENCY

We,

....

....

of

(a) "all the" or "the majority of the" as the case may be.

being (a) Directors of

Limited

do solemnly and sincerely declare that we have made a full inquiry into the affairs of this company, and that, having done so, we have formed the opinion that this company will be able to pay its debts in full within a period of (b) months, from the commencement of the winding-up, and we append a statement of the company's assets and liabilities as at 19 being the latest practicable date before the making of this declaration And we make this solemn declaration, conscientiously believing the same to be true, and by virtue of the provisions of the Statutory Declarations Act, 1835

(b) Insert a period of months not exceeding twelve.

Declared at

the day of

One thousand nine hundred and

before me.

(c) A Commissioner for Oaths.

(c) or Notary Public or Justice of the Peace.

Statement as at .. ..19..

showing Assets at estimated realizable values and Liabilities expected to rank.

ASSETS AND LIABILITIES				Estimated to Realize or to Rank for Payment (to nearest £)
ASSETS—				£
Balance at Bank				
Cash in hand				
Marketable Securities				
Bills Receivable				
Trade Debtors				
Loans and Advances				
Unpaid Calls				
Stock-in-Trade				
Work in Progress				
Freehold Property				
Leasehold Property				
Plant and Machinery				
Furniture, Fittings, Utensils, etc.				
Patents, Trade Marks, etc.				
Investments other than marketable securities				
Other property, viz.:				
Estimated realizable value of Assets			£	
LIABILITIES—				
Secured on specific assets, viz.:		£		
Secured by Floating Charge(s)				
Estimated Cost of Liquidation and other expenses including interest accruing until payment of debts in full				
Unsecured Creditors (amounts estimated to rank for payment)—	£			
Trade accounts				
Bills Payable				
Accrued Expenses				
Other Liabilities:				
Contingent Liabilities:				
Estimated Surplus after paying Debts in full			£	

Remarks:

The differences of detail between the Deficiency Account in bankruptcy and compulsory liquidation are—

	BANKRUPTCY	COMPULSORY LIQUIDATION
Commencing item	Excess of Assets over Liabilities [or conversely]	Excess of Assets over Capital and Liabilities (or *vice versa*).
Date of commencing item	*One* year before the Receiving Order—or as Official Receiver otherwise orders	*Three* years before the Winding-up Order, or as the Official Receiver directs, where the company has been in existence for at least a period of three years, otherwise from the date of formation, unless the Official Receiver otherwise directs
Details	(*a*) *Net* Profit (or Loss) (*b*) Other profits (or losses) including those arising out of the valuations of Assets and Liabilities in the Statement of Affairs	See form on page 1241.

So far as the details in the Statement of Affairs are concerned Debentures will not occur in Bankruptcy, nor Deferred Debts in Liquidation

Liquidator Carrying on Business. When the liquidator carries on the company's business he must keep a trading account and cash book including all receipts and payments Costs and expenses properly incurred in the course of the liquidation are payable in priority to the liquidator's remuneration Taxation arising by reason of the business being carried on by the liquidator is included in this class of expense and the Crown therefore takes priority to the liquidator (*In re Beni-Felkai Mining Co, Ltd*) This priority must be distinguished from the preferential claim for taxation due at the commencement of the winding up which falls within the general class of preferential creditors referred to earlier in this chapter and which rank after the liquidator's remuneration

CHAPTER XXXII

MANUFACTURING ACCOUNTS

In previous chapters no reference has been made to the preparation of the final accounts of a manufacturer.

These accounts will, in addition to the Trading and Profit and Loss, contain a separate section from which will be ascertained the cost of manufacture of the goods or articles. Such information will be prepared on the usual double entry lines, and in almost all well-organized concerns will be linked up with an efficient costing system. The limits of space will not permit of any detailed explanation of Cost Accounts, embodying, as they do, an exceptional number of technical features; so that no reference will be made thereto except in so far as is required to make the present chapter comprehensible.

The "Manufacturing Account" is the account employed to show the cost of manufacture or production: and, ignoring for the present the question of quantities or units produced, the rules for compilation may be summarized thus—

(1) The cost of goods consumed is ascertained by means of inset figures or a separate sub-account containing (*a*) commencing stock of raw materials; (*b*) raw materials purchased; (*c*) carriage of raw materials; less (*d*) closing stock of raw materials; and (*e*) by-products and/or rejected raw material. The items (*a*), (*b*), (*c*) are debits, and (*d*), (*e*) are credits posted in the usual way from the Ledger Accounts. Unfortunately, students tend to lose sight of the essentially simple factors, especially where the credit item takes the form of a deduction instead of being presented in the familiar way.

(2) To the total of (1) are added the wages of employees whose work is such that it is directly identified with manufacture, such expenditure being known as direct wages. The total now presented is the prime cost. It may here be stated that authorities on this subject hold divergent views on the precise meaning of the term, some maintaining that depreciation of machinery may be justifiably included in the prime cost; but on this and other controversial topics the student is advised to conform to the orthodox method, making such comments as are desirable in connection with the controversial points—unless, indeed, an opinion is definitely called for.

(3) To the prime cost are added the factory[1] or works or indirect expenses of manufacture, which will include some or all of the following, according to circumstances—

Works power, rent, rates, heating, lighting, depreciation of machinery (connected with manufacture), works internal transport,

[1] Alternatively described as Factory Oncost.

works manager's salary, proportion of directors' remuneration, proportion of cost of experiment, repairs to works, store keeping, and other indirect wages. The total now presented is the **gross works cost of manufacture.**

(4) The partly finished goods or work in progress, as distinct from completely manufactured goods, must now be brought into account. The work in progress at the commencement of the period will be debited, and the work in progress at the close of period be credited (and debited to Work-in-progress Account) OR the two figures may be shown in inset form, the net difference of which will be either added to or deducted from the total as ascertained in (3). The difference, as mentioned, will be deducted where it reflects an INCREASE of work in progress at the close over that at the commencement, and added where it reflects a DECREASE. The result arising from this entry gives the **net works cost of manufacture.**

(5) Where there are by-products or rejected material, the amount thereof (usually at estimated realizable value) is deducted before arriving at the net works cost of manufacture. The deduction will be made either from the raw materials purchased or from the gross cost according to circumstances.

The net works cost of manufacture will be transferred to the Trading Account and will be treated therein just as goods purchased in the case of a non-manufacturing concern. The Trading and Profit and Loss Account may be prepared on the usual lines or a further subdivision thereof made, e.g. in three sections—

(*a*) The administration expenses are added to the works cost of manufacture in order to obtain the total cost of manufacture.

(*b*) This section, which is the Trading Account, commences with the stock of FINISHED goods at the commencement of the period, to which is added the total of (*a*); the credit side includes sales of finished goods and stock of finished goods at the end of the period, the balance giving the gross profit on goods sold (or gross loss).

(*c*) The balance on (*b*) is carried down into this final section and the selling and distribution expenses are debited, leaving the net result of the period. This is the ordinary Profit and Loss Account.

Quantities. Where quantities of goods enter into the question, it is necessary to observe the following general principles—

(1) Columns to record quantities should be ruled.

(2) Quantities of goods will be compiled on the ordinary principle, viz. the commencing quantity plus that received should equal the quantity transferred or sold plus that remaining on hand at the close.

(3) Quantities of raw materials and work in progress will appear only in the Manufacturing Account, but quantities of FINISHED goods may appear in both the Manufacturing and the Trading Account.

(4) Where, as is frequently the case, incomplete data is furnished in the question, it is necessary to piece together such links of information disclosed, and to this end, unless the facts in the question

definitely state otherwise or the inferences are inconsistent therewith, the student should assume that the opening and closing stocks are valued on a uniform basis. This applies particularly to stock of finished goods.

In the vast majority of cases the information required to disclose quantities, although incomplete, is such that the required figure is ascertainable by building up the accounts in skeleton form. The varieties of problems are so numerous that no rule can be enunciated to cover them, and constant practice is necessary to enable a student to become proficient in readily perceiving the connecting links.

As an extremely simple example, a question may disclose the fact that 1,000 units have been sold at £2 each; that the opening and closing stocks of finished goods were 200 and 100 units respectively valued at £1 10s. each. This will automatically disclose the fact that apart from exceptional circumstances the influx of finished goods is 900 units from the manufacturing section, this being the balancing figure of quantities.

This aspect of Manufacturing Accounts is important, and several illustrations will follow in order that the student may become thoroughly familiar with the method of obtaining complete accounts from incomplete data.

(5) Where there is a discrepancy in quantitative results the amount thereof should be shown as a separate item so that the quantity columns balance.

Illustration. The following items appear in the Trial Balance of a company as at 30th June, 19..—

	Dr. £		*Dr.* £	*Cr.* £
Stock, 1st January, 19..—		*Depreciation (contd.)*—		
Finished Goods (1,600 tons)	16,380	Factory and Buildings	400	
Work in Progress	1,000	Lease of City Office	500	
Raw Materials	8,640	Factory Wages	156,000	
Chemicals	390	,, Oncost	12,000	
Purchases—		Sales (35,400 tons)		400,000
Raw Materials	142,620	Carriage Outwards	2,320	
Chemicals (net price)	12,370	Salaries	22,400	
Depreciation—		General Expenses	18,310	
Plant	16,000	Trade Discounts on Materials		3,400
		Cash Discounts allowed	5,100	

Stock, 30th June, 19..: Finished Goods, 1,200 tons, £12,380.
Raw Materials, £6,860; Work in Progress, £2,000; Chemicals, £760.

Prepare accounts of the results of the operations for the half-year ended 30th June, 19... (See page 1248.)

It will be observed that the Trading Account in this illustration has been debited with actual cost, but the practice frequently obtains to charge up trading with the "outside" cost, that is, the cost as if the finished goods had been purchased from suppliers instead of being manufactured in the proprietor's own factory.

Dr. MANUFACTURING, TRADING, AND PROFIT AND LOSS ACCOUNTS FOR THE HALF-YEAR ENDED 30TH JUNE, 19. . **Cr.**

		£	£				£
To Stock—Raw Materials (Opening)			8,640	By Cost of Manufacture			
,, Purchases		142,620		35,000 tons at £9·61 per ton [1]	c/d		336,400
Less Trade Discount		3,400	139,220				
			147,860				
Less Stock (Closing)			6,860				
Raw Materials consumed			141,000				
,, Stock—Chemicals (Opening)		390					
,, Purchases		12,370					
		12,760					
Less Stock (Closing)		760	12,000				
Deduct			153,000				
Work in Progress—							
Closing		2,000					
Less Opening		1,000	1,000				
			152,000				
,, Factory Wages			156,000				
,, Factory Oncost			12,000				
,, Power			7				
,, Depreciation—							
Machinery and Plant		16,000					
Factory and Buildings		400	16,400				
			£336,400				£336,400
		Tons	£			Tons	£
To Stock—Finished Goods		1,600	16,380	By Sales		35,400	400,000
,, Transfer of Finished Goods from Factory	b/d	35,000	336,400	,, Stock		1,200	12,380
,, Gross Profit	c/d		59,600				
		36,600	£412,380			36,600	£412,380
To Salaries			22,400	By Gross Profit	b/d		59,600
,, General Expenses			18,310				
,, Carriage Outwards			2,320				
,, Discounts			5,100				
,, Depreciation—							
Lease of City Office			500				
,, Net Profit			10,970				
			£59,600				£59,600

[1] This quantity figure constitutes the connecting link for quantities of finished goods.

The principle is similar, but there will be required additionally—

(1) A transfer from the Manufacturing Account to Profit and Loss Account in respect of Manufacturing Profit (or possibly Loss), thus: if a profit—

Debit Manufacturing Account.
Credit Profit and Loss Account.

If a loss—

Debit Profit and Loss Account.
Credit Manufacturing Account.

(2) An adjustment for unsold finished stock in the selling department (or trading section), because until the goods are sold there is no real profit, although internal profit may have arisen as a result of the transfers of finished goods at loaded prices from the manufacturing section to the trading section. These adjustments are dealt with below.

(3) Where, in addition to trading in goods manufactured in one's own factory, similar goods have to be purchased from others, the cost will be charged to Trading Account in the ordinary way. This point is illustrated on page 1251.

Illustration. One hundred units of goods are manufactured at a cost of £2, all of which are transferred to Selling Department at £2 10s. a unit. Selling Department expenses are 4s. a unit sold. Sales are £110, representing a selling price of £2 15s. a unit.

Show Manufacturing Account and Profit and Loss Account of Selling Department.

Dr. MANUFACTURING ACCOUNT *Cr.*

		Units	£			Units	£
	To Cost . . .	100	200		By Transfer to Selling Department . .	100	250
	,, Profit and Loss Account . .		50				
		100	£250			100	£250

SELLING DEPARTMENT

Dr. PROFIT AND LOSS ACCOUNT *Cr.*

		Units	£			Units	£
	To Transfer from Manufacturing Account . .	100	250		By Sales . .	40	110
	,, Selling Expenses .		8		,, Stock at "Cost"	60	150
	,, Profit and Loss Account . .		2				
		100	£260			100	£260

Dr. GENERAL PROFIT AND LOSS ACCOUNT *Cr.*

			£				£
	To Provision for Profit on Unsold Stock . .	[1]	30		By Transfer—Profit from: Manufacturing Account . . .		50
	,, Balance—Profit . .		22		Selling Department .		2
			£52				£52

[1] This is arrived at by taking 60 units at 10s. [i.e. a loaded price £2 10s *less* true price £2]; or taking one-fifth of £150 as the loading is 25 per cent. of cost, which is 20 per cent of selling price. Both calculations give £30.

If the manager is to take a proportion of the profits of the Manufacturing Department, it is part of the cost, so that the true cost will be increased by the amount given to the manager. To take an exaggerated supposition, if the manager took ALL the profit the true cost would be £250, i.e. £2 10s. a unit, so that the "loading" over true price is nil. Hence there will be no provision for profit on unsold stock, and the credit to General Profit and Loss Account disappears, the £50 being credited to the personal account of the manager.

It will be seen, therefore, that the *greater* the proportion of manufacturing profit given to the manager, the *lesser* is the loading.

Illustration. The same facts as in the preceding illustration, except that the manager is to be credited with 20 per cent of the profits of the Manufacturing Department. Show the accounts.

The manufacturing profit will be £40 only, £10 being transferred to the credit of the Manager. The Selling Department Profit and Loss Account remains unaffected.

Dr. GENERAL PROFIT AND LOSS ACCOUNT *Cr.*

		£			£
To Provision for Profit on Unsold Stock[1]		24	By Transfer Profit from—Manufacturing Account		40
,, Balance—Profit		18	Selling Department		2
		£42			£42

The results can readily be proved by the following rough account built up by ignoring the loading—

Dr. PROFIT AND LOSS ACCOUNT *Cr.*

	Units	£		Units	£
To Cost	100	200	By Sales	40	110
,, Manager's Commission		10	,, Stock[2]	60	126
,, Selling Expenses		8			
,, Balance—Profit		18			
	100	£236		100	£236

Illustration. A company has three departments: mill, factory, and selling. The goods manufactured by the mill are invoiced to the factory at 20 per cent on mill cost, and the factory sells to the Selling Department at a profit of 10 per cent on factory cost. From the following details prepare accounts—

	£
Cost of Goods (Mill)	50,000
Opening Stock of Mill Goods in Factory at "loaded" price	6,540
Closing Stock of Mill Goods in Factory at "loaded" price	12,540
Other Purchases and Expenses of Factory	13,500
Selling Department Expenses	5,650
Closing Stock of Factory Goods in Selling Department at "loaded" price	22,275
Opening Stock of Factory Goods in Selling Department	*nil*
Sales	65,625

[1] This is arrived at by taking 60 units at 10s., *less* one-fifth, that is, 60 at 8s., or £24. It is clear that the true cost of 100 units is £210, viz. £2 2s. each, as against the internal invoice price of £2 10s., disclosing a loading of 8s.

[2] This is arrived at by taking 60 at £2 2s.; or $\frac{60}{100}$ × £210.

Dr. **Mill Manufacturing Account** *Cr.*

	£		£
To Cost	50,000	By Transfer to Factory	60,000
,, General Profit and Loss Account	10,000		
	£60,000		£60,000

Dr. **Factory Manufacturing Account** *Cr.*

		£		£
To Goods—			By Transfer to Selling Department	74,250
Stock (Opening)	£ 6,540			
Purchases	60,000			
	66,540			
Less Stock (Closing)	12,540			
		54,000		
,, Other Purchases and Expenses		13,500		
		67,500		
,, General Profit and Loss Account		6,750		
		£74,250		£74,250

Selling Department

Dr. **Profit and Loss Account** *Cr.*

	£		£
To Transfer from Factory	74,250	By Sales	65,625
,, Selling Department—Expenses	5,650	,, Stock at "Cost"	22,275
,, General Profit and Loss Account	8,000		
	£87,900		£87,900

Dr. **General Profit and Loss Account** *Cr.*

	£		£
To Provision for increase of Mill Stock in Factory $\frac{1}{6}$ × £6,000 [£12,540 − £6,540]	1,000	By Profit—	
,, Provision for increase of Factory Stock in Selling Department: $\frac{1}{11}$ × £22,275	2,025	Mill	10,000
,, Provision for increase of Mill Stock in Selling Department (*a*)	2,700	Factory	6,750
,, Balance—Profit	19,025	Selling Department	8,000
	£24,750		£24,750

(*a*) The computation is as follows—

The true cost of Factory Goods (for which a provision has been created) is £22,275 *less* $\frac{1}{11}$ thereof = £20,250.

But the true cost of Factory Goods is made up of the following—

	£
Mill Goods	54,000
Other Goods, etc. . . .	13,500
	£67,500

This shows a ratio of 4 : 1, thus for every £1 of Factory Cost, four-fifths represents Mill Goods at loaded price; hence $\frac{4}{5}$ × £20,250 is attributable to Mill Goods at the cost to the Factory, that is, at loaded price. This amounts to £16,200. As this figure includes mill profit, it is necessary to create a provision for its elimination of $\frac{1}{6}$ of £16,200 = £2,700,

[The final provision may be arrived at, alternatively, by taking the increase of goods in Selling Department, dividing it by the total transfer value from factory, and multiplying by the loading of Mill Goods in factory. Thus—

$$\frac{\text{Increase of goods}}{\text{Transfer value from factory}} \times \text{Mill loading in factory}$$

i.e. $\frac{22,275}{74,250} \times \frac{54,000}{6} = \frac{3}{10} \times 9,000 = £2,700$]

It is clear that the loading on £54,000 is £9,000, so that if there is no increase of factory stock in the Selling Department, no provision is necessary; if, on the other hand, no sales were made, there would be an increase of factory stock in the Selling Department of all the factory goods, so that the whole of the loading of £9,000 would require to be provided for. As in the above case the increase of factory goods in Selling Department is three-tenths, the provision is $\frac{3}{10}$ × £9,000 = £2,700.

General Illustration. M, Ltd., has two departments, one manufacturing, the other merchanting. Stocks are issued from a central store to both departments. You are required to compile quantitative and financial Manufacturing and Trading Accounts to show the profit or loss on each department from the following figures—

	Quantity in lb.	£
Stock of Raw Materials in stores at beginning of year	5,680	852
Purchases.	250,080	38,554
Stores issued—		
Manufacturing Department . . .	152,640	
Merchanting Department	100,000	
Works Charges—		
Materials		3,000
Wages		4,000
Expenses		1,500
Depreciation		1,000
Stock of Manufactured Goods at beginning of year.	10,040	4,016
Stocks at close of year—		
Raw Materials in Stores	3,120	481
Manufactured Goods in Manufacturing Dept. .	2,680	1,072
General Expenses—		
Manufacturing Department		2,100
Merchanting Department		900
Buying expenses to be apportioned on the basis of the quantities respectively used in each Dept. .		2,000

	Quantity in lb.	£
Sales—		
Manufacturing		44,884
Merchanting		17,500
Sales of Waste Products by Manufacturing Dept. .	50,080	834

Interest on capital at 5 per cent per annum to be charged to each department on the basis of capital employed, namely, £20,000 and £16,000 respectively.

Dr. STORES ACCOUNT *Cr.*

	lb.	Pence per lb	£	s	d.		Lb.	Pence per lb	£	s	d
To Stock of Raw Materials	5,680	36 0	852	0	0	By Issues— Merchanting Department	100,000		15,407	6	0
„ Purchases	250,080	37 0	38,554	0	0	Manufacturing Department	152,640		23,517	14	0
						„ Stock of Raw Materials c/d	3,120	37·0	481	0	0
	255,760	£	39,406	0	0		255,760	£	39,406	0	0
To Stock of Raw Materials b/d	3,120	37 0	481	0	0						

It is assumed that stocks are issued proportionately to materials used and to the departments on the basis of "first in, first out." Thus the 5,680 is first issued, proportionately to materials used.

The buying expenses are to be apportioned between the departments in the ratio of materials used, so that the total could be charged to Stock Account and the issues would then be loaded in the correct proportions.

Dr. PROFIT AND LOSS ACCOUNT *Cr.*

		£		£ s. d		£
To Balance .	c/d	6,849	By Net Profit— Manufacturing Dept.	5,447 19 10	b/d	
			Less Loss— Merchanting Dept.	398 18 10	b/d	[1]5,049
			„ Interest on Capital .			1,800
		£6,849				£6,849
			By Balance . . .		b/d	6,849

[1] From page 1255.

Dr. **MANUFACTURING ACCOUNT** Cr.

		Lb.	£	s.	d.			Lb.	£	s.	d.
To Issue of Raw Materials		152,640	23,517	14	0	By Sales of Waste Products		50,080	834	0	0
,, Works Materials			3,000	0	0	,, Production of Stock	c/d	102,560	33,392	1	2
,, Wages			4,000	0	0						
,, Expenses			1,500	0	0						
,, Depreciation			1,000	0	0						
,, Buying Expenses $\frac{152640}{252640} \times$ £2,000			1,208	7	2						
		152,640	£34,226	1	2			152,640	£34,226	1	2

Dr. **MANUFACTURED STOCK ACCOUNT** Cr.

		Lb.	£	s.	d.			Lb.	£	s.	d.
To Stock of Finished Materials		10,040	4,016	0	0	By Stock— Finished Materials		2,680	1,072	0	0
,, Cost of Production	b/d	102,560	33,392	1	2	,, Cost of Sales to Trading Account[1]	c/d	109,920	36,336	1	2
		112,600	£37,408	1	2			112,600	£37,408	1	2

[1] To page 1255.

Dr. **TRADING ACCOUNT** *Cr.*

		Merchanting Department £	s.	d.	Manufacturing Department £	s.	d.			Merchanting Department £	s.	d.	Manufacturing Department £	s.	d.
To Cost of Sales—								By Sales		17,500	0	0	44,884	0	0
Issue of Goods . £15,407 6 0								,, Loss[1] . . .	c/d	398	18	10			
Buying Expenses $\frac{100000}{252640} \times$ £2,000 791 12 10		16,198	18	10											
,, Cost of Sales	b/d				36,336	1	2								
,, General Expenses		900	0	0	2,100	0	0								
,, Interest on Capital . . .		800	0	0	1,000	0	0								
,, Profit[1]	c/d				5,447	18	10								
		£17,898	18	10	£44,884	0	0			£17,898	18	10	£44,884	0	0

[1] To page 1253.

Illustration. Four companies entered into a pooling agreement under which they were to pay into a joint account their profits of each year.

The amount of the joint pool was to be applied first in making good the amount of any deficit of a member and then the balance was to be divided among all the members in proportion to their share capital.

The results of the first year of the arrangement were—

	A	B	C	D
	£	£	£	£
Share Capital	160,000	150,000	120,000	270,000
Sales	45,000	62,000	32,000	140,000
Opening Stock	4,000	6,000	9,000	20,000
Closing Stock	5,000	8,000	4,000	16,000
Purchases	19,000	33,000	18,000	80,000
Expenses	15,000	23,000	13,000	37,000

Make up the Pool account showing the amounts each member will pay in or draw out.

Another company, E, is invited to join the Pool. Its profits are £16,000 on a share capital of £300,000.

Calculate what benefit, if any, there would be to E if it joined the Pool on the assumption that, if E joins, economies amounting to £9,000 a year can be made in the expenses of the five companies.

STATEMENT OF PROFITS

	A		B		C		D	
	£	£	£	£	£	£		£
Sales		45,000		62,000		32,000		140,000
Less Opening Stock	4,000		6,000		9,000		20,000	
Purchases	19,000		33,000		18,000		80,000	
	23,000		39,000		27,000		100,000	
Closing Stock	5,000		8,000		4,000		16,000	
	18,000		31,000		23,000		84,000	
Expenses	15,000	33,000	23,000	54,000	13,000	36,000	37,000	121,000
	Profit	£12,000	Profit	£8,000	*Loss*	£4,000	Profit	£19,000

Total Profits (net)	£ 35,000
Total Share Capital	£700,000
Percentage on Capital	5%

Dr. POOL ACCOUNT *Cr.*

	£		£
To Deficit—C	4,000	By Profits—	
„ Balance, divisible proportion to Capital—		A	12,000
A $\frac{160,000}{700,000} \times$ £35,000 [5% on £160,000]	8,000	B	8,000
B $\frac{150,000}{700,000} \times$ £35,000 [5% on £150,000]	7,500	D	19,000
C $\frac{120,000}{700,000} \times$ £35,000 [5% on £120,000]	6,000		
D $\frac{270,000}{700,000} \times$ £35,000 [5% on £270,000]	13,500		
	£39,000		£39,000

A therefore pays in net £4,000, B £500 and D £5,500 making a total of £10,000 which C draws out.

If E joins the Pool, the total capital and profits will be—

	Capital	*Profit*
	£	£
A, B, C, and D . .	700,000	35,000
Add E . . .	300,000	16,000
,, Economies .		9,000
	£1,000,000	£60,000 [6% on total Capital]

E's share of the total profits will be—

	£
$\frac{300}{1,000} \times$ £60,000	18,000
Deduct E's existing profit.	16,000
Benefit to E by joining Pool . . .	£2,000

	%	
Note.—The previous return on E's Capital was .	5⅓	(£16,000 on £300,000)
Under the Pool it will be	6	(£18,000 on £300,000)
Gain	⅔%	

Gain of ⅔% on £300,000 = £2,000

[In practice, the item of expenses would be segregated into Manufacturing, Administrative, Selling and Distribution Expenses].

Illustration. The following summary is prepared from the accounts of the Packing Manufacturers, Ltd. for the year 19. .—

	£
Material consumed	30,000
Wages of Operatives	12,100
Overhead Expenses	8,000
	50,100
Net Profit	4,900
Sales	£55,000

The following material facts exist—

(1) The year is a normal year.

(2) All operatives are paid on the basis of a 44 hour week of which four hours are taken up each Saturday morning for general clearing up and maintenance.

(3) The materials used vary considerably in quality and price.

(4) A small portion of the materials purchased is merchanted and sold at a profit of 5 per cent on cost.

(5) No special sales staff is employed on this portion of the company's business.

(6) The sales of merchanted goods are £6,300; and the costs applicable thereto £100.

Prepare statement showing results of (*a*) manufacturing and (*b*) merchanting.

	£	£	
Manufacturing—			
Materials consumed	30,000		
Less Cost of Merchanted Goods:			
$\frac{20}{21} \times$ £6,300	6,000		
		24,000	
Wages of Operatives	12,100		
Less value of time on Clearing up and Maintenance:			
$\frac{1}{11} \times$ £12,100	1,100		
		11,000	
Overhead Expenses	8,000		
Add Labour Cost as above . . .	1,100		
	9,100		
Less Proportion attributable to Merchanting	100		
		9,000	
		44,000	
Sales			48,700
Net Profit		4,700	
		£48,700	£48,700
Merchanting—			
Cost of Goods		6,000	
Attachable Expenses		100	
		6,100	
Sales			6,300
Net Profit		200	
		£6,300	£6,300

Note. (i) It is assumed that a uniform percentage of profit will arise from all the jobs undertaken.

(ii) A satisfactory statement is impossible in the absence of separation of overheads, e.g. into Manufacturing, Administration, Selling, and Distribution.

Illustration. Plastics, Ltd. manufacture their products through two processes, 1 and 2.

The output of process 1 is transferred to process 2 at a price which shows process 1 a profit of $33\frac{1}{3}$ per cent on cost; and the output of process 2 is transferred to the Selling Department at a price which shows process 2 a profit of 25 per cent on cost.

The following information is provided for the year ended 31st December, 19...

	Process 1	*Process 2*
	£	£
Stock, 1st January, 19.. . . .	210	90
Materials used	800	700
Direct Labour	1,000	914
Oncost	300	184
Stock, 31st December, 19.. . .	180	128

The above stocks are those which have passed through the process and are valued at *prime cost* to the process concerned.

The stock of finished goods in the Selling Department (which handles no "outside" goods) at 1st January, 19.., and 31st December, 19.., was £620 and £800 respectively.

Sales during the year ended 31st December, 19.., were £6,086.

The Provisions for unrealized profit included in the stock valuation at the commencement of the year were: Process 2 £16; Finished Goods £214.

The manager of process 2 is entitled to 20 per cent of the net profit of his department before charging such percentage.

Assuming that all the stock at 1st January, 19.. (commencement of the year), had been sold during the year, show Process Accounts and a Trading Account together with a *pro forma* composite memorandum account proving the trading profit as shown in the Trading Account.

Process Accounts

Dr. FOR THE YEAR ENDED 31ST DECEMBER, 19.. *Cr.*

	Process 1		Process 2			Process 1	Process 2
	£	£	£	£		£	£
To Stock, Opening		210		90	By Transfer to Process 2	2,840	
,, Materials used	800		700		,, Transfer to Trading Account		5,750
,, Direct Labour	1,000		914				
,, Process 1			2,840				
Prime Cost	1,800		4,454				
,, Oncost	300		184				
		2,100		4,638			
		2,310		4,728			
Less Stock, Closing		180		128			
		2,130		4,600			
,, Manager's Commission			230				
,, Profit		710	920				
				1,150			
		£2,840		£5,750		£2,840	£5,750

Trading Account

Dr. FOR THE YEAR ENDED 31ST DECEMBER, 19.. *Cr.*

		£			£
To Stock, Opening		620	By Sales		6,086
,, Finished Goods from Process 2		5,750	,, Stock, Closing		800
,, Gross Profit c/d		516			
		£6,886			£6,886
To Provision for unrealized Profit, Closing: c/f			By Gross Profit b/d		516
			,, Provision for unrealized Profit, Opening: b/f		
Process 2	£20		Process 2	£16	
Finished Goods	230		Finished Goods	214	
		250			230
,, Trading Profit		496			
		£746			£746

Calculation of closing Provision—

Process 2 Stock:

25 per cent of $\frac{2,840}{4,454}$ of £128		20
Finished Goods—		
80 per cent of 20 per cent of £800	128	
25 per cent of $\frac{2,840}{4,454}$ of (£800 – £160)[1]	102	
		230
		£250

Dr. MEMO. ACCOUNT Cr.

	Process 1	Process 2		Process 1	Process 2
	£	£		£	£
To Stock, Opening	210	(a) 74	By Transfer	2,130	
„ Materials used	800	700	„ Transfer c/d		4,124
„ Direct Labour	1,000	914			
„ Process 2		2,130			
„ Oncost	300	184			
	2,310	4,002			
Less Stock, Closing	180	(b) 108			
	2,130	3,894			
„ Manager's Commission		230			
	£2,130	£4,124		£2,130	£4,124
To Stock, Opening		(c) 406	By Sales		6,086
„ Finished Goods b/d		4,124	„ Stock, Closing		(d) 570
„ Gross Profit		2,126			
		£6,656			£6,656

Profit per Accounts—	£
Process 1	710
Process 2	920
Trading	496
As per Memo.	£2,126

(a) Stock at cost, £90 – £16 [Opening Provision].
(b) Stock at cost, £128 – £20 [Closing Provision].
(c) Stock at cost, £620 – £214 [Opening Provision].
(d) Stock at cost, £800 – £230 [Closing Provision].

EXAMINATION PROBLEM

X Y Z Co., Ltd., manufactures lemon squash. Prepare from the following balances and records Manufacturing, Trading and Profit and Loss Accounts, showing in them such percentages and figures per case as will furnish costing information and facilitate periodical comparisons.

Stocks at cost on 1st January, 19..—	£
Bottled Lemon Squash	2,112
Ingredients	4,784
Bottles, etc.	1,226

[1] I.e. $\frac{2,840}{4,454}$ × (£800 – $\frac{1}{5}$ of £800), being the proportion of Process 2 cost before adding either the company's 80 per cent or the manager's 20 per cent of the profit added thereto.

	£
Purchases—	
Ingredients	10,432
Bottles, etc.	3,128
Factory Wages	5,120
Factory Expenses	628
Factory Rent.	594
Carriage Inwards	382
Distributing Charges	522
Office Salaries and Expenses	2,080
Selling Expenses	904
Stocks at cost on 30th June, 19..—	
Ingredients	3,775
Bottles, etc.	1,007
Sales	26,294

The stock of bottled lemon squash on 30th June, 19.., was 12,500 cases; 7,000 cases produced during the period had been invoiced out at £1,824 and treated as sales, but were still held by customers on sale or return on 30th June, 19...

Messina lemons purchased at 24s. a case during the year 19.. have been found unsuitable for manufacture; the sales include 1,260 cases of these lemons sold during the period at 18s. a case, and 180 cases were still in stock on 30th June, 19.., when the market value was 16s. a case.

100,000 cases of bottled lemon squash were produced during the six months.

(*Institute of Chartered Accountants, Final.*)

It is essential that the lemons unsuitable for the manufacture of lemon squash which were sold should be treated separately. A Lemon Trading Account should be opened and the profit or loss on these dealings separately ascertained. The account would appear as follows—

Dr. LEMON TRADING ACCOUNT *Cr.*

		Cases	£			Cases	£
To Stock eliminated from Production Account [See note *b*]		1,440	1,728	By Lemons Sold		1,260	1,134
				,, Stock of Lemons		180	144
				,, Loss transferred to Profit and Loss Account.			450
		1,440	£1,728			1,440	£1,728

Dr. SALES ACCOUNT (*d*) *Cr.*

		£			£
To Lemons Sold		1,134	By Sales (as per question)		26,294
,, Lemon Squash on Sale or Return	c/d	1,824			
,, Profit and Loss Account		23,336			
		£26,294			£26,294
			By Balance	b/d	1,824

The balance of £1,824 is deducted from debtors in the Balance Sheet.

See page 1262 for Manufacturing, Trading, and Profit and Loss Account.

X Y Z CO., LTD.

Dr. MANUFACTURING, TRADING AND PROFIT AND LOSS ACCOUNT FOR THE SIX MONTHS ENDED 30TH JUNE, 19 . **Cr.**

					% on Manufacturing Cost	Cost per Case				Cost per Case	
			£	£		£	£			£	£
	To Stock of Ingredients, 1st January 19		4,784					By Manufacturing Cost of 100 000 Cases .	c/d	0·200	20,000
	Add Purchases		10,432								
			15,216								
(a)	*Less* Cost of Lemons unsuitable for manufacture		1,728								
(b)			13 488								
	Less Stock, 30th June, 19		3,559	9,929							
	,, Stock of Bottles, etc — 1st January, 19		1,226								
	Add Purchases.		3,128								
			4 354								
	Less Stock, 30th June, 19		1,007	3 347							
	,, Carriage Inwards .			382							
	Materials Consumed				68 29	0 137	13,658				
	,, Factory Wages .				25 60	0·051	5,120				
	,, Factory Expenses				3 14	0 006	628				
	,, Factory Rent [Rates ?]				2 97	0 006	594				
					100 00	0 200	£20,000			0 200	£20,000
					Cases			By Sales . .		0 256	23,336
	To Stock, 1st Jan., 19				10,560		2 112				
	,, Manufacturing Cost (x) [see page 1263]	b/d			100 000		20,000				
					110,560		22,112				
(c)	*Less* Stock, 30th June, 19				19,500		3,900				
	Cost of Cases Sold .				91,060	0 200	18,212				
	,, Gross Profit .	c/d				0 056	5,124				
						0 256	£23 336			0 256	£23,336

		£			£
To Office Salaries		2,080	By Gross Profit . .	b/d	5,124
,, Distributing Charges		522			
,, Selling Expenses		904			
,, Loss on Lemons sold		450			
Net Profit for Half Year	c/f	1 168			
		£5 124			£5 124

(*a*) As has been stated above, the dealings in unsuitable lemons must be entirely eliminated from the Production Account. The stock of ingredients (£3,775) includes such lemons at cost, hence a deduction therefrom of 180 cases of lemons at 24s. [i.e. cost] is required, whatever the latter are now worth, so that the stock of ingredients will be as follows—

	£
Stock as per question	3,775
Less 180 cases of Lemons at 24s. per case . .	216
Balance	£3,559

The current value of the 180 cases is included in the Lemon Trading Account.

(*b*) The unsuitable lemons were originally included at cost in the purchases; but as these do not now form part of the cost of production, they must be eliminated at cost and debited to Lemon Trading Account, which shows the dealings in unsuitable lemons.

(*c*) The closing stock of 12,500 cases must be supplemented by the stock of cases out on sale or return, the latter having been deleted from Sales. [See Sales Account (*d*).]

(*d*) The Sales figure given includes goods out on sale or return and unsuitable lemons, both of which must be deleted. (See accounts above.)

(*e*) No mention is made in the question of the cost of the cases, but it is assumed that such is included in the phrase "bottles, etc."

[Alternatively, the goods sent out on Sale or Return may be retained in the Trading Account and a provision created for the unearned profit. This provision will be £424, being £1,824 *less* Cost £1,400. The latter is 7,000 at 4s. a case. Thus the gross profit will be increased by £424 to £5,548, but as the provision will be deducted in the Profit and Loss section, the net profit will remain unchanged. The Stock on hand (neither sold nor out on Sale or Return) will be £2,500. Sales will be increased by £1,824 to £25,160.]

The account will then read (from part on page 1262 marked x)—

Dr.			*Cr.*
	£		£
To Stock, 1st Jan., 19.. .	2,112	By Sales and deliveries on Sale or Return . .	**25,160**
,, Manufacturing Cost .	20,000		
	22,112		
Less Stock, 30th June, 19..	**2,500**		
Cost of Sales . .	**19,612**		
Gross Profit c/d . .	**5,548**		
	£25,160		**£25,160**
	£		£
To Loss on Lemons sold .	450	**By Gross Profit b/d . .**	**5,548**
,, Office Salaries . .	2,080	*Less* **Provision on 7,000 Cases on Sale or Return . .**	**424**
,, Distributing Charges .	522		
,, Selling Expenses .	904		
,, Net profit for half-year c/f	1,168		
	£5,124		**£5,124**

Alternative figures are in heavy type.

EXAMINATION PROBLEM

Pennyworths, Ltd., commenced business on 1st January, 19... They manufacture automatic machines, place them on sites rented at one-fifth of the takings, and sell penny packets of peppermints through them.

The company purchased the peppermints at 2s. 4d. per box of 48 packets, and are given one box free with every six boxes purchased.

Pennyworths, Ltd., also sell machines to shopkeepers, to whom they supply peppermints at 2s. 4d. per box.

From the following particulars you are required to make up the Company's Accounts for the year ended 31st December, 19..—

	£	s.	d.
Sales of Peppermints through Machines	56,000	0	0
Sales of Peppermints to Machine-owners . . .	2,100	0	0
Purchases of Peppermints, 350,000 boxes at 2s. 4d.. .	40,833	6	8
Stock of Peppermints in Depots on 31st December and in Machines at date of last collection, 52,000 boxes at 2s. 4d.	6,066	13	4
Purchases of Manufacturing Material	50,000	0	0
Sales of Machines, 1,000 at £7 each (at factory) . .	7,000	0	0
Stock of Manufacturing Material on 31st December. .	5,000	0	0
Work in Progress on 31st December	4,500	0	0
Manufacturing Wages	9,000	0	0
Rents of Machine Sites	11,200	0	0
Machine Repairers' Wages	1,400	0	0
Manufacturing Rent, Rates, etc.	5,000	0	0
Expenses of Collection from Machines	5,600	0	0
Bonus on Purchase of Peppermints	5,833	6	8
Overhead Expenses (apportionable in ratio of net purchases)	1,700	0	0

The following amounts to be written off for depreciation, etc.—

Manufacturing plant and machinery, £300; machines on sites, 10 per cent of cost, including £3,666 13s. 4d. for fixing on sites; loose tools, jigs, patterns, etc., £200.

Credit is to be taken for uncollected sales in the machines, estimated at £1,000.

During the year 11,000 machines were manufactured for the company's own use. (*Institute of Chartered Accountants, Final.*)

MANUFACTURING, TRADING AND PROFIT AND LOSS

Dr. ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 19.. *Cr.*

	£	£		£	£
To Manufacturing Materials purchased	50,000		By Site Transfers *at cost*— 11,000 Machines		51,333⅓
Less Stock at end . .	5,000		,, Sales—		
		45,000	1,000 Machines at £7 each .		7,000
,, Manufacturing Wages		9,000			
,, Manufacturing Rent, Rates, etc.		5,000			
,, Depreciation— Plant and Machinery . .	300				
Loose Tools, Jigs, Patterns, etc. .	200				
		500			
Carried forward .		59,500	*Carried forward* .		58,333⅓

Manufacturing Trading and Profit and Loss Account —(*contd.*)

Dr. | *Cr.*

		£	£			£	£
Brought forward .			59,500	*Brought forward* .			58,333⅓
To Overhead Expenses $\frac{50,000}{85,000} \times £1,700$.			1,000				
			60,500				
Less Work in Progress .			4,500				
Cost of Manufacture of 12,000 Machines .			56,000				
,, Gross Profit on Machines sold .	c/d		2,333⅓				
			£58,333⅓				£58,333⅓

		Boxes	Machines on Sites	Machine Owners			Boxes	Machines on Sites	Machine Owners
			£	£				£	£
To Purchases *less* Bonus, at 2/- a Box, net .	[3]	332,000	33,200		By Sales at 4s. a Box		285,000	57,000	
,, Ditto .	[3]	18,000		1,800	,, Ditto 2/4	[1]	18,000		2,100
,, Rent of Sites .	[4]		11,400		,, Stock 2/-	[2]	47,000	4,700	
,, Gross Profit .	c/d[5]		17,100	300					
		350,000	£61,700	£2,100			350,000	£61,700	£2,100

		£			£
To Machine Repairers' Wages .		1,400	By Gross Profit .	b/d	17,100
,, Collection Expenses .	[7]	5,700			
,, Overhead Expenses— $\frac{35,000}{85,000} \times £1,700$.		700			
,, Depreciation of Machines .	[8]	5,500			
,, Net Profit .	c/d	3,800			
		£17,100			£17,100

General Profit and Loss Account

Dr. | *Cr.*

		£			£
To Balance .	c/d	6,433⅓	By Manufacturing Profit.	b/d	2,333⅓
			,, Profit on Sales of Peppermints—		
			To Machine Owners	b/d	300
			On Sites .	b/d	3,800
		£6,433⅓			£6,433⅓
			By Balance .	b/d	6,433⅓

It is assumed that the Repairs item is exclusive to Repairs of Machines on Sites.

[See *Notes* on page 1266.]

Notes. (1) SALES.

		£	£
(*a*)	280,000 Boxes at 4s. each	56,000	
(*b*)	5,000 Boxes at 4s. each	1,000	57,000
(*c*)	18,000 Boxes at 2s. 4d. each		2,100
	303,000		£59,100

(2) STOCK.

Boxes

52,000 as per question.
Less 5,000 (see (1) (*b*) above).
47,000 at 2s. each. (See (3) below.) £4,700

[Alternatively, the Stock may be calculated thus—
Boxes
350,000 purchased
303,000 sold
47,000 left.]

(3) COST OF BOXES.

	Per Box *s.*	*d.*	£
350,000 purchased at 2s. 4d.	2	4	40,833⅓
Less Bonus		4	5,833⅓
350,000	2	0	£35,000

(4) RENT OF SITES.

	£
One fifth of Sales "lifted," £56,000	11,200
Add Provision of one fifth of Sales not yet "lifted," £1,000	200
	£11,400

(5) GROSS PROFIT *re* "SITE" SALES.

	s.	*d.*	*s.*	*d.*
Selling Price per Box— 1d. per packet = 4s. per Box containing 48 packets			4	0
Cost (*a*) purchase price, net, per Box [see (3)].	2	0		
(*b*) Rent of site—one-fifth of 4s.		9·6		
			2	9·6
Gross Profit			1	2·4
285,000 at 1s. 2·4d.			£17,100	

(6) DEPRECIATION.

	£
Cost of Machines $\frac{11}{12}$ of £56,000	51,333⅓
Add Cost of fixing, as per question	3,666⅔
	£55,000
10 per cent thereof	£5,500

(7) COLLECTION EXPENSES.

The cost of collection works out at 10% on sales "lifted" (i.e. £5,600), so that a provision of £100 on the "unlifted" sales has been made, although 10% may be purely a coincidence.

CHAPTER XXXIII

BANK BOOK-KEEPING

THE business of the banker for the most part involves dealing with large sums of currency, including bills of exchange. Owing to the magnitude of the transactions involved, the accounting system entails the use of a large number of subsidiary and memorandum books, the employment of the slip system of posting, and the daily balancing of cash. It will be apparent that the principles of book-keeping are not difficult of application in view of the fact that most of the entries refer to cash transactions.

The key book is the General Cash Book, which summarizes the various receipts and payments for the day. As, however, the manifold activities of the bank require a large staff, it will be essential to have a correspondingly large number of subsidiary books of prime entry, the totals of which are incorporated into the general Cash Book. The chief subsidiary books are—

(1) **Receiving Cashier's Counter Cash Book.** On receipt of money over the counter, the cashier enters the amount into his Counter Book.

(2) **Paying Cashier's Counter Cash Book.** On payment of customers' cheques the cashier enters such payments into his Counter Book; in addition, he invariably inserts a note in a memorandum column of the numbers of any bank-notes paid.

(3) **Received Waste Book.** This book is used in order to facilitate the collection of cheques. It is analysed according to the mode of collection involved. As the student is aware, certain cheques are collected through the Town Clearing, others through the Metropolitan Clearing, others through the Country Clearing, such cheques being coded at the foot by the letters T, M, or C, as the case may be. In addition, separate columns are employed for Bank of England and Walks cheques. The latter are cheques drawn on bankers not represented in the Clearing House, so that the amounts have to be collected, the messenger having to "walk" to the paying banker.

(4) **Bills Discounted Ledger.** This is an important book in which are entered the receipts of bills for discount. When a customer discounts a bill of exchange the following entries are made by the Bank—

	(i) Debit Bills Discounted Account Credit customer	for the face value of the bill
	(ii) Debit customer Credit Discounts Account	for the discounting charges
	(iii) Debit Cash Credit Bills Discounted Account	upon payment at maturity
or	(iiia) Debit customer Credit Bills Discounted Account	upon dishonour

In addition, a book called an Acceptor's Book is kept which records the acceptances of any one person: it is obvious that a large number of acceptances by any one person might cause the bank to decline to discount bills drawn on that particular person.

There are other books which, important as they are, merely serve as a guide to the bank in its activities, the chief of which are the Bills Received for Collection Register and Bills Received for Discount Register.

The following transactions, considerably simplified and curtailed, are taken to illustrate a typical day's working of a bank. The full entries are given below to show the principles already outlined. Obviously in practice the amounts involved are considerably greater and are far more numerous.

Illustration. The opening balances of X Bank on 4th January, 19.., are as follows—

	£	£
Cash	2,200	
Bank of England	10,500	
Branches		8,500
Current Accounts		10,100
Bills for Collection	2,000	
Bills Discounted	2,500	
Interest on Deposits	20	
Bills Payable (usually described as Acceptances for customers)		417
Discounts		15
Acceptances (usually described as Acceptances for customers)	417	
[1]Sundry Fixed Assets (Investments, Premises, etc.)	30,000	
[1]Special Reserve		605
[1]Share Capital		15,000
[1]Reserve		12,000
[1]Profit and Loss Account		1,000
	£47,637	£47,637

From the foregoing balances and the General Cash Book entries as shown on the following page, write up—

(1) Ledger Accounts and
(2) Trial Balance.

The preparation of the Profit and Loss Account and Balance Sheet arising from these transactions is illustrated on pages 1272 and 1273.

[1] As these items remain undisturbed, Ledger Accounts therefor are not opened.

Dr. General Cash Book, 4th January, 19..	£	*Dr.*	£
To Current Accounts paid in	6,200	By Current Accounts drawn out . .	4,130
„ Balances overdrawn—Current Accounts paid in . .	4,100	„ Balances overdrawn—Current Accounts drawn out . .	5,060
„ Bills Discounted . .	300	„ Bills Discounted . .	518
„ Bills for Collection .	820	„ Bills for Collection .	432
„ Branches . . .	1,110	„ Branches . . .	719
„ Bank of England. .	5,180	„ Bank of England .	6,319
„ Bills Payable . .	240	„ Acceptances . .	240
„ Acceptances . .	485	„ Bills Payable . .	485
„ Discounts . . .	5	„ General Expenses .	40
	18,440		17,943
„ Balance from 3rd Jan., 19.. . . .	2,200	„ Balance to 5th Jan., 19 .	2,697
	£20,640		£20,640

LEDGER ACCOUNTS

[After showing the first account with date and particulars, merely the money items will be entered in this illustration.]

Cash

Date	Particulars	*Dr.*	*Cr.*		Balances
19..		£	£		£
Jan. 3	To Balance			*Dr.*	2,200
4	„ Cash Book	18,440			
	„ „		17,943	*Dr*	2,697

Bank of England

					Balances
		£	£		£
		6,319		*Dr.*	10,500
			5,180	*Dr.*	11,639

Branches

					Balances
		£	£		£
		719		*Cr.*	8,500
			1,110	*Cr.*	8,891

Current Accounts

					Balances
		£	£		£
		9,190		Cr.	10,100
			10,300	Cr.	11,210

Bills Discounted

					Balances
		£	£		£
		518		Dr.	2,500
			300	Dr.	2,718

Bills for Collection

					Balances
		£	£		£
		432		Dr.	2,000
			820	Dr.	1,612

Bills Payable

					Balances
		£	£		£
		485		Cr.	417
			240	Cr.	172

Interest on Deposits

					Balances
					£
				Dr.	20
				Dr.	20

Discounts

					Balances
			£		£
				Cr.	15
			5	Cr.	20

Acceptances

					Balances
		£	£		£
		240		Dr.	417
			485	Dr.	172

General Expenses

					Balances
		£			£
		40		Dr.	40

TRIAL BALANCE, 4TH JANUARY, 19 .

	Dr.	Cr.
	£	£
Cash	2,697	
Bank of England	11,639	
Branches		8,891
Current Accounts		11,210
Bills Discounted	2,718	
Bills for Collection	1,612	
Bills Payable (acceptances for customers)		172
Interest on Deposits	20	
Discounts		20
Acceptances (liability of customers for acceptances)	172	
General Expenses	40	
Sundry Fixed Assets	30,000	
Special Reserve		605
Share Capital		15,000
Reserve		12,000
Profit and Loss Account		1,000
	£48,898	£48,898

Many other accounts will be necessitated such as Deposit and Loan Accounts.

Slip System. In connection with the accounts of bankers, attention may be drawn to the use of the slip system, although this system, it should be observed, is not confined to bankers.

The principle involved is to make the postings from the slip itself, without recording an original entry in a subsidiary book.

The advantages are briefly—

(1) Avoidance of loss of time in posting.

(2) As the slips are almost invariably filled up by outside parties such part of the book-keeping is done free of cost, e.g. insurance commission receipt slips completed by an agent on receipt of commission, paying-in slips, etc.

(3) Frequently the keeping of the subsidiary book may be entirely dispensed with, but where it is necessary to employ such book the postings both into the Ledger and the subsidiary book can be performed almost simultaneously.

On the other hand, the disadvantages are—

(1) Risk of loss, misappropriation or destruction.

(2) Difficulty in the verification of the books.

In particular, the use in banks of the Slip System is important by reason of—

(1) The necessity for the accounts to be accurate and complete up to the very minute.

(2) The enormous number of transactions.

(3) The assistance it affords in evening the flow of work.

(4) The manifold uses of the slips in the bank's accounting system generally.

Use of the Slip System. The cashier on receipt of a customer's lodgments enters the amount in his Cash Received Counter Book; the paying-in slip will then be entered by a ledger clerk to the credit of the customer's account so that the complete double entry is effected.

On the same principle, the cashier on payment of a customer's cheque enters the payment into his Cash Paid Counter Book, and the cheque is thereupon handed to a ledger clerk and entered by him to the debit of the customer's account.

This method is necessitated by the important need for the banker to have his customer's account correct at all times; this could not be done if the ledger clerks were compelled to await the time when the Received and Paid Counter Cash Books were free. Quite apart from the fact that there is far more detailed work for one ledger clerk to perform by way of posting, it is obviously impracticable for several clerks to be posting from the Cash Book at the same time.

The same method is adopted in respect of other transactions, such as on the issue of cheques and transfers, e.g. from Current Account to Deposit Account.

Final Accounts. No particular difficulty arises in preparing the final accounts of a bank. The most important matters for the student to remember are—

(1) The sequence of assets in the Balance Sheet.

(2) The treatment of rebates on bills discounted. (See page 173.)

Illustration. From the Trial Balance shown in the preceding illustration, prepare the Profit and Loss Account and Balance Sheet, assuming that the rebate for bills discounted is £3, and dividends and interest accruing to the bank amount to £55. [The illustration is founded upon the Trial Balance already drawn up for the sake of completing the book-keeping records, although it is clear that a Profit and Loss Account would not be drawn up in respect of one day's transactions.]

Dr. PROFIT AND LOSS ACCOUNT FOR THE .. *Cr.*

		£			£
To Interest on Deposits		20	By Dividends . . .		55
,, General Expenses .		40	,, Bills Discounted . .	[1]	17
,, Profit	c/d	12			
		£72			£72

[1] I.e. £20 of which £3 is carried forward.

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

		£			£
To Balance	c/f	1,012	By Balance	b/f	1,000
			,, Profit	b/d	12
		£1,012			£1,012

BALANCE SHEET AS AT .

	£		£
Nominal Capital			
Issued Capital	15,000	Cash in hand	2,697
Reserve	12,000	Bank of England	11,639
Special Reserve	605	Bills Discounted	2,718
Profit and Loss Account	1,012	Bills for Collection	1,612
Branch Accounts	8,891	Dividends Accruing	55
Current Accounts	11,210	Acceptances (liability of customers for acceptances)	172
Bills Payable (acceptances for customers)	172	Sundry Fixed Assets	30,000
Rebate on Bills Discounted	3		
	£48,893		£48,893

The Profit and Loss Account and Balance Sheet would, in practice, contain many other items.

Having followed the example previously given, the student will have no difficulty in understanding the final accounts of a bank containing the detailed Ledger Accounts.

Illustration. The following are the balances of the Mersey and Irwell Bank, Ltd., at the 31st December, 19. ..

TRIAL BALANCE, 31ST DECEMBER, 19. .

	Dr. £	*s.*	*d.*	*Cr.* £	*s.*	*d.*
Share Capital—						
250,000 Shares of £20 each, £3 paid				750,000	0	0
137,500 Shares of £10 each, £1 paid				137,500	0	0
Reserve				500,000	0	0
Current Accounts				2,581,342	11	4
Deposit Accounts				685,134	12	1
Endorsements for Customers				161,598	16	3
Acceptances for Customers				178,617	2	5
Final Dividend				56,004	15	8
Cash in hand	341,643	19	7			
Bank of England	621,858	1	10			
Money at Call and Short Notice	279,416	4	8			
Bills Discounted	833,482	16	6			
Advances to Customers	1,342,119	17	6			
Carried forward	£3,418,521	0	1	£5,050,197	17	9

TRIAL BALANCE, 31ST DECEMBER, 19..—(*contd.*)

	Dr. £	s.	d.	Cr. £	s	d.
Brought forward	3,418,521	0	1	5,050,197	17	9
Liability of Customers for Endorsements	161,598	16	3			
Liability of Customers for Acceptances	178,617	2	5			
Bank Premises at Cost, less w/o .	260,000	0	0			
Shares in Subsidiary Companies at Cost	248,000	0	0			
Shares in Affiliated Companies at Cost .	168,000	0	0			
Balances with, and Cheques in course of Collection on, other Banks . .	224,218	9	8			
Investments at Cost	618,357	14	9			
Profit and Loss Account—						
Balance 1st Jan., 19.., forward .				128,138	19	9
Interest Received				141,009	14	2
Discount Charges				38,461	2	11
Commission Charges . . .				154,858	12	3
Interest Paid and Allowed. . .	42,048	1	2			
General Expenses	191,362	8	8			
Dividends Received, *less* Tax . .				86,250	11	0
Dividends—						
Interim	32,188	9	2			
Provision for Final . . .	56,004	15	8			
	£5,598,916	17	10	£5,598,916	17	10

You are required to prepare a Profit and Loss Account and Balance Sheet after taking into account the following adjustments—

(i) Rebate on bills discounted, £3,271 4s. 8d.

(ii) £20,000 to be allocated to Reserve.

Items bracketed are to be shown under one heading in the Balance Sheet, thus conforming with usual practice.

PROFIT AND LOSS ACCOUNT

Dr. FOR THE YEAR ENDED 31ST DECEMBER, 19.. *Cr.*

		£	s	d			£	s	d
To Interest allowed to Customers .		42,048	1	2	By Interest charged to Customers .		141,009	14	2
,, General Expenses		191,362	8	8	,, Discounts . .		35,189	18	3
,, Balance to Profit and Loss Appropriation Account	c/d	183,898	5	10	,, Commissions .		154,858	12	3
					,, Dividends, *less* Tax . .		86,250	11	0
		£417,308	15	8			£417,308	15	8

Dr. PROFIT AND LOSS APPROPRIATION ACCOUNT *Cr.*

		£	s	d			£	s.	d
To Interim Dividend		32,188	9	2	By Balance (1st Jan.)	b/f	128,138	19	9
,, Provision for Final Dividend. .		56,004	15	8	,, Profit and Loss Account .	b/d	183,898	5	10
,, Reserve .		20,000	0	0					
,, Balance . .	c/f	203,844	0	9					
		£312,037	5	7			£312,037	5	7

Note. In the published accounts *only* the details in the Profit and Loss Appropriation Account would be disclosed.

MERSEY AND IRWELL BANK, LTD.

Balance Sheet as at 31st December, 19 .

	£	s.	d.			£	s.	d.
Nominal Share Capital	....	..	..	Coin, Bank Notes, and Balances with the Bank of England		963,502	1	5
Issued Share Capital—				Balances with, and Cheques in course of collection on, other Banks		224,218	9	8
250,000 Shares of £20 each, £3 paid £750,000				Money at Call and Short Notice		279,416	4	8
137,500 Shares of £10 each, £1 paid 137,500	887,500	0	0	Investments at Cost		618,357	14	9
Reserve	520,000	0	0	Bills Discounted		833,482	16	6
Profit and Loss Account	203,844	0	9	Advances to Customers		1,342,119	17	6
	1,611,344	0	9	Shares in Subsidiary Companies at Cost	£248,000			
Dividend (Proposed)	56,004	15	8	Shares in Affiliated Companies at Cost	168,000			
	1,667,348	16	5			416,000	0	0
Current and Deposit Accounts	3,266,477	3	5	Liability of Customers for Acceptances and Endorsements *per contra*		340,215	18	8
Acceptances and Endorsements on account of Customers *per contra*	340,215	18	8	Bank Premises at Cost, *less* Depreciation		260,000	0	0
Rebate for Bills Discounted	3,271	4	8					
	£5,277,313	3	2			£5,277,313	3	2

[It should be observed that where pressed for time in examination work, the student may show the Assets in one figure, as follows—

	£	s.	d.
Assets—Total as per question	5,598,916	17	10
Less Sundry revenue items (the last four *Dr.* items in Trial Balance)	321,603	14	8
	£5,277,313	3	2

There will be added the auditors' report and other details required by the Companies Act, 1948, including group accounts, subject to Eighth Schedule, Part III.

CHAPTER XXXIV

MISCELLANEOUS

Foreign Exchange. In businesses involving numerous transactions in foreign currency it is necessary to distinguish those payable in *sterling* (although invoiced in foreign currency) from those payable in *foreign currency*. Hence, the former will be entered in the books in the usual way, the foreign currency equivalent where applicable entered by way of Memorandum only. As to the transactions involving receipts and payments in terms of foreign currency, the Day Books and Ledgers will be ruled with two columns on each side, one for foreign currency and one for sterling. The invoices will be entered in the foreign currency column and converted into sterling at parity or other suitable rate. Alternatively, the sterling column may be completed by insertion of the actual sterling figure when the payment is made. Unless the latter method is adopted there will usually be a difference between the sterling figure so converted and that arising upon payment, such difference being transferred to a Difference on Exchange Account or Profit and Loss on Exchange Account.

In many instances a trader will enter into a forward exchange contract whereby a banker arranges to supply sterling for foreign currency or *vice versa* at a rate of exchange determined, not at the time the delivery of the sterling or foreign currency is made, but at the time the **arrangement** is made, e.g. an English trader may have sold goods to a French trader, payment for which is to be made in three months' time. The former may assure himself of the precise amount of sterling he is to receive at the end of three months by entering into a forward exchange contract with his banker *immediately*, under which the latter undertakes to acquire French francs and supply sterling at the date required at a rate of exchange fixed at the date of making the arrangement.

In order to ascertain the true position in these circumstances the trader should convert the foreign currency at the ruling rate of exchange as if the position had not been secured by the forward exchange transaction; and record the difference arising from the forward exchange transaction, thus affording information both as to (i) the profit or loss that would have resulted if no forward exchange transaction had taken place; and as to (ii) the profit or loss on the forward exchange contract.

Where there are numerous accounts involving foreign currency, the provision for loss (if any) may be made by taking the *total* sterling value against the *total* currency value, thus dealing with the situation as a whole instead of considering separately each individual balance.

Illustration. Addingham sold goods to Montreux Frères payable

in francs. The invoice amounted to 1,350,000 francs, the rate of exchange being 900 to £. Upon remittance the banker credited Addingham with the proceeds of the francs, the sterling equivalent being £1,551 14s. 6d., i.e. 1,350,000 francs at 870 to £.

No arrangement had been made for forward exchange.

Show the Ledger Account of Montreux Frères in the seller's books.

Dr. MONTREUX FRÈRES *Cr.*

	Francs	Rate	Sterling £	s.	d.		Francs	Rate	Sterling £	s.	d.
To Goods .	1,350,000	900	1,500	0	0	By Remittance.	1,350,000	870	1,551	14	6
,, Profit and Loss on Exchange Account .			51	14	6						
	1,350,000		£1,551	14	6		1,350,000		£1,551	14	6

Normally, the ultimate difference in exchange will be ascertained at the end of the accounting period.

Illustration. Same facts as above, except that Montreux Frères pay by two remittances of 600,000 francs at 920 and 750,000 at 890.

Show the Ledger Account of Montreux Frères in the seller's books.

Dr. MONTREUX FRÈRES *Cr.*

	Francs	Rate	Sterling £	s.	d.		Francs	Rate	Sterling £	s.	d.
To Goods .	1,350,000	900	1,500	0	0	By Remittance.	600,000	920	(a)652	3	6
						,, ,, .	750,000	890	(b)842	13	11
						,, Profit and Loss on Exchange Account.			5	2	7
	1,350,000		£1,500	0	0		1,350,000		£1,500	0	0

If the difference in exchange were transferred on the occasion of each remittance, the foregoing account would show (*a*) a loss of £14 9s. 10d., and (*b*) a profit of £9 7s. 3d. Similar principles apply where the English trader is a debtor.

Illustration. The Paris agents of a London firm, having collected certain moneys on behalf of their principals from French debtors have in hand a sum of 4,500,000 francs. In the London books this amount of currency is converted into sterling at 900 to £.

On instructions, the agents purchase 1,600 French 5 per cent bonds of 2,500 francs each (nominal) at 99½ per cent, of which they sell 96 bonds at 102 per cent, remitting the proceeds to their principals, the rate of exchange being 880 to £.

Shortly afterwards the London firm make up their books, the then current rate of exchange being 920 to £. Show the accounts the London firm would keep to record these transactions, disclosing the profits or losses on the investment and on the foreign exchange fluctuations. Ignore expenses.

Paris Agents

Dr. | Cr.

		Francs	Rate	£	s.	d.			Francs	Rate	£	s.	d.
To Balance	b/d	4,500,000	900	5,000	0	0	By Purchase of Bonds		3,980,000	880	4,522	14	7
,, Sale of Bonds		2,448,000	880	2,781	16	4	,, Cash		2,448,000	880	2,781	16	4
,, Profit on Exchange				87	18	11	,, Balance	c/d	520,000	920	565	4	4
		6,948,000		£7,869	15	3			6,948,000		£7,869	15	3
To Balance	b/d	520,000	920	565	4	4							

French Five per Cent Bonds

Dr. | Cr.

		No.	Nominal Francs	Price Francs	Rate	£	s.	d.			No.	Nominal Francs	Price Francs	Rate	£	s.	d.
To Purchase of Bonds		1,600	4,000,000	3,980,000	880	4,522	14	7	By Sale of Bonds		960	2,400,000	2,448,000	880	2,781	16	4
,, Profit on Bonds				60,000	880	68	3	7[1]	,, Balance	c/d	640	1,600,000[2]	1,592,000	880	1,809	1	10
		1,600	4,000,000	4,040,000		£4,590	18	2			1,600	4,000,000	4,040,000		£4,590	18	2
To Balance	b/d	640	1,600,000	1,592,000	880	1,809	1	10	By Balance	c/d	640	1,600,000	1,592,000	920	1,730	8	8
									,, Loss on Exchange						178	13	2
		640	1,600,000	1,592,000		£1,809	1	10			640	1,600,000	1,592,000		£1,809	1	10
To Balance	b/d	640	1,600,000	1,592,000	920	1,730	8	8									

[1] The net result is a loss of £10 9s. 7d., i.e. £78 13s. 2d. *less* £68 3s. 7d. The amount of £78 13s. 2d. is a loss of $\frac{4}{92}$ of £1,809 1s. 10d.

[2] The proportion of Bonds at COST (ignoring market value), viz. $\frac{64}{160}$ of 3,980,000 francs = 1,592,000 francs. [See Note 3, page 1279.]

If the detail shown on page 1278 is not required, the account may be constructed as follows—

Dr. FRENCH FIVE PER CENT BONDS *Cr.*

		No.	*Nominal Francs*	Sterling £	s.	d.			No.	*Nominal Francs*	Sterling £	s.	d.
To Purchases		1,600	4,000,000	4,522	14	7	By Sale		960	2,400,000	2,781	16	4
							" Balance	c/d	640[1]	1,600,000	1,730	8	8
							" Loss				10	9	7
		1,600	4,000,000	£4,522	14	7			1,600	4,000,000	£4,522	14	7
To Balance	b/d	640	1,600,000	1,730	8	8							

[1] i.e. $\frac{64}{160}$ of 3,980,000 francs at 920 = 1,592,000 francs at 920.

NOTES (1) If the shares had been valued at *par*, the balance would be $\frac{64}{160}$ of 4,000,000 = 1,600,000 francs at 920.

(2) If the valuation in (1) had been made *ignoring* rate of exchange, the balance would be 1,600,000 francs at 880.

(3) If the shares had been valued at *cost*, ignoring rate of exchange, the balance would be $\frac{64}{160}$ [i.e. $\frac{2}{5}$] of £4,522 14s. 7d. = £1,809 1s. 10d. This is the same as $\frac{2}{5}$ of 3,980,000 francs at 880, as shown in the French Five per Cent Bonds Account marked [1] on page 1278.

Forward Exchange. If the trader had entered into a forward exchange transaction with the banker, the position would be modified according to the rate so arranged. The accounting entries would be the same as previously outlined, together with those necessary to record the profit or loss by reason of having covered in advance the conversion of his foreign currency. The entries may therefore be summarized.

(1) Debit Foreign Currency Suspense Account in sterling at the rate ruling at the date of receipt and credit customer therewith.

(2) Credit or debit the customer so far as relates to the particular remittance to close the account, transferring the amount to Profit or Loss on Exchange Account.

So far the entries are similar to those outlined in the case where the trader has not entered into a forward exchange transaction except that in (1) the debit is to Foreign Currency Suspense Account instead of cash or bank.

(3) Debit bank and credit Foreign Currency Suspense Account with the proceeds of the foreign currency at the rate of exchange *previously* agreed upon between the trader and the banker when the forward exchange transaction was negotiated.

(4) Close the Foreign Currency Suspense Account to Profit or Loss on Forward Exchange Account.

Illustration. Serra Frères owe Johnson 1,800,000 francs, rate of exchange upon the date of sale being 900 francs to £. On the same date Johnson entered into a forward exchange contract at 880 to £. When Serra Frères remitted the rate of exchange was 910 to £. Show accounts in Johnson's books. (See page 1281.)

Superannuation Schemes. Many businesses now have in operation schemes whereby superannuation and pensions are provided for when employees retire at a certain age. In order to provide against hardship in the case of a person dying or ceasing to be employed, arrangements are made for payment of a lump sum to the estate of the deceased, or to the ex-employee.

The schemes vary considerably in detail and in a great number of cases arrangements are made with leading assurance offices whereby in consideration of an annual premium, the liability for implementing the scheme is taken over by the assurance office.

Where the employer elects to take responsibility himself without arrangements with an assurance office the accounting will vary, as stated, but the essential principle is the same, viz. by having a nucleus fund of income-bearing investments, followed by annual or other periodical contributions by both employer and employees, a reasonably certain income is derived from which to provide the payments and augment the fund. Special arrangements are required in the early years of a scheme for the older employees who will not

Dr. **SERRA FRÈRES** Cr.

	Francs	Rate	£	s.	d.		Francs	Rate	£	s.	d.
To Goods	1,800,000	900	2,000	0	0	By Remittance	1,800,000	910	1,978	0	5
						,, Profit or Loss on Exchange Account			21	19	7
	1,800,000		£2,000	0	0		1,800,000		£2,000	0	0

Dr. **BANK** Cr.

	£	s.	d.		£	s.	d.
To Foreign Currency Suspense Account	2,045	9	1				

Dr. **FOREIGN CURRENCY SUSPENSE** Cr.

	Francs	Rate	£	s.	d.		Francs	Rate	£	s.	d.
To Serra Frères	1,800,000	910	1,978	0	5	By Bank	1,800,000	880	2,045	9	1
,, Profit or Loss on FORWARD EXCHANGE Account			67	8	8						
	1,800,000		£2,045	9	1		1,800,000		£2,045	9	1

Note. The wide differences in exchange given in the question would not obtain in practice.

have the opportunity to pay in for a sufficiently long period of years to benefit.

Periodically, a revaluation will be taken of the actuarial risk involved (similar to the actuarial valuation of an assurance company) and the fund adjusted accordingly.

The contributions made by employers and employees under, and in accordance with, a scheme approved by the Inland Revenue under Sect. 379, Income Tax Act, 1952[1] will be allowed as admissible charges against their respective profits or income for income tax purposes. To obtain such approval the main conditions are—

(1) The Superannuation Fund is created under a Trust that is irrevocable and trustees appointed.

(2) The *sole* (or main) object is to provide superannuation for employees (widows, children, or dependants).

(3) The employer contributes to the fund.

(4) The scheme is recognized both by the employer and employees.

Application for official approval must be made *in writing* by the trustees of the fund before the end of the year of assessment, supported by a certified copy of the Trust Deed and two copies of the rules agreed thereunder. Investment income of an approved fund is exempted from Income Tax.

Illustration. Under the rules of the Engee Company Staff Superannuation Fund a member, when he becomes superannuated, is entitled to an annuity, based on the amount standing to his credit.

The Annuity and General Funds are kept separate, and interest received on investments is apportioned between the funds in proportion to the mean of the opening and closing balance for the year (*before* crediting such interest). Any surplus (or deficiency) on the Annuity Fund enures to (or has to be borne by), the General Fund, and for this purpose a valuation of the liabilities for the annuities is made every three years.

From the following data show the Annuity Fund and General Fund for the years 1952 and 1953.

Ignore Tax deductions or repayments.

	1952 £	1953 £
Balance at 1st January, 1952—		
Annuity Fund, £9,000		
General Fund, £87,000		
Interest on Investments	5,000	5,400
Contributions of Employer and Employees	9,000	8,200
Payments to Annuitants	1,000	1,200
Amounts standing to the credit of Employees who became superannuated during the year	3,000	2,200

A valuation was taken on 31st December, 1952, and showed the liability for current annuities at £12,000.

[1] Previously Sect. 32, Finance Act, 1921.

ANNUITY FUND

Dr.							*Cr.*
			£				£
1952 Dec. 31	To Cash—Annuitants .		1,000	1952 Jan. 1	By Balance . .	b/d	9,000
	,, Balance, per Valuation . . .	c/d	12,000	Dec. 31	,, General Fund, *re* Employees Superannuated . .		3,000
					,, Interest on Investments ($\frac{1}{10}$) . .		500
					,, General Fund for Deficiency . .		500
			£13,000				£13,000
1953 Dec. 31	To Cash—Annuitants .		1,200	1953 Jan. 1	By Balance. . .	b/d	12,000
	,, Balance . . .	c/d	13,600	Dec. 31	,, General Fund, *re* Employees Superannuated . .		2,200
					,, Interest on Investments ($\frac{1}{9}$) . .		600
			£14,800				£14,800
				1954 Jan. 1	By Balance. . .	b/d	13,600

GENERAL FUND

Dr.							*Cr.*
			£				£
1952 Dec. 31	To Annuity Fund—Transfer thereto for Superannuated Employees . .		3,000	1952 Jan. 1	By Balance. .	b/d	87,000
	,, Annuity Fund—Transfer *re* Deficiency . .		500	Dec. 31	,, Contributions .		9,000
	,, Balance. . .	c/d	97,000		,, Interest on Investments ($\frac{9}{10}$) .		4,500
			£100,500				£100,500
1953 Dec. 31	To Annuity Fund—Transfer thereto for Superannuated Employees . .		2,200	1953 Jan. 1	By Balance . .	b/d	97,000
	,, Balance. . .	c/d	107,800		,, Contributions .		8,200
				Dec. 31	,, Interest on Investments ($\frac{8}{9}$) . .		4,800
			£110,000				£110,000
				1954 Jan. 1	By Balance. . .	b/d	107,800

Note. *Apportionment of Interest—*

	Annuity Fund 1952		Annuity Fund 1953		General Fund 1952		General Fund 1953
	£		£		£		£
Opening. . . .	9,000		12,000		87,000		97,000
Closing (9,000 + 3,000 − 1,000) .	11,000	(12,000 + 2,200 − 1,200)	13,000	(87,000 + 9,000 − 3,000)	93,000	(97,000 + 8,200 − 2,200)	103,000
	2)20,000		2)25,000		2)180,000		2)200,000
Mean . . .	£10,000		£12,500		£90,000		£100,000
	(*a*)		(*c*)		(*b*)		(*d*)

1952. Interest. . . . $= \frac{a}{a+b} \times 5{,}000$ Interest $= \frac{b}{a+b} \times 5{,}000$

$= \frac{10}{100} \times 5{,}000 = £500$ $= \frac{90}{100} \times 5{,}000 = £4{,}500$

1953. Interest. . . . $= \frac{c}{c+d} \times 5{,}400$ Interest $= \frac{d}{c+d} \times 5{,}400$

$= \frac{12\frac{1}{2}}{112\frac{1}{2}} (\frac{1}{9}) \times 5{,}400 = £600$ $= \frac{100}{112\frac{1}{2}} (\frac{8}{9}) \times 5{,}400 = £4{,}800$

Illustration. The Superannuation Fund of Elbee Co., Ltd. commenced in 1946 under an approved Trust Deed. All employees thereunder are to benefit. In order that due recognition should be given to length of service *prior* to the formation of the fund the company undertook to form a Reserve Fund to provide a nucleus for claims arising through death or retirement of members who had been in the company's employment prior to 1946. The estimated liability on this account at 1st January, 1953, was £7,000.

The following balances appeared in the books at 31st December, 1953—

	£
Contributors' Account (Balance, 1st January, 1953)	2,340
Employees' Contributions	740
Company's Contributions	560
Amount contributed by Company from Reserve Fund in respect of deceased employees' services prior to 1946	330
Claims and Withdrawals	410
Interest on Investments (less Tax at 9s.)	88
Printing and Stationery	20
Revenue Account (*Cr.*), 1st January, 1953	100
Investments at Cost	3,600
Cash at Bank	128

Interest on employees' balances amounting to £95 is to be provided out of Revenue Account; company's contributions of £60 in respect of employees who have left are to be surrendered and credited to Revenue Account under the scheme. Provision is to be made for audit of £21. Ignore tax charged at $\frac{1}{4}$ standard rate on withdrawals.

(1) Calculate the company's liability on Reserve Fund as at 31st December, 1953, after crediting interest amounting to £275 on the balance of the account at the commencement of the year.

(2) Prepare Revenue Account and Contributors' Account for the year to and Balance Sheet as at 31st December, 1953.

(1) *In Company's books*—

	£
Reserve Fund, 1st January, 1953	7,000
Add Interest thereon	275
	7,275
Less Contribution to Superannuation Fund	330
Balance, 31st December, 1953	£6,945

(2) *In the books of the Trust*—

Dr. CONTRIBUTORS' ACCOUNT *Cr.*

			£				£
1953 Dec. 31	To Cash—Claims and Withdrawals		410	1953 Jan. 1	By Balance	b/d	2,340
	" Revenue Account—Transfer thereto for Company's Contribution for Employees who have left		60	Dec. 31	" Contributions—Employees		740
	" Balance	c/d	3,595		Company		560
					Reserve Fund		330
					" Revenue Account—Transfer therefrom for Interest on Employees' Balances		95
			£4,065				£4,065
				1954 Jan. 1	By Balance	b/d	3,595

REVENUE ACCOUNT Cr.

1953			£	1953				£
Dec. 31	To Printing and Station'ry		20	Jan. 1	By Balance .	b/d		100
	„ Contributors' Account Transfer thereto for Interest.		95	Dec. 31	„ Interest on Investments—Net			88
	„ Audit		21		„ Tax recoverable: £160 at 9s in £			72
	„ Balance	c/d	184		„ Contributors' Acct.—Transfer therefrom for Contributions surrendered			60
			£320					£320
				1954				
				Jan. 1	By Balance	b/d		184

BALANCE SHEET AS AT 31ST DECEMBER, 1953

	£		£
Contributors' Account	3,595	Investments at Cost .	3,600
Revenue Account	184	[Market Value?]	
Reserve Fund .	6,945	Inland Revenue	72
Provision for Audit .	21	Cash at Bank .	128
		Company	6,945
	£10,745		£10,745

Illustration. The Rules of a Staff Superannuation Scheme are—

(1) Equal contributions by employer and members (to be credited to members' accounts).

(2) The payment to a member, on retirement through age or infirmity, of an annuity *actuarially* calculated to be of a value equal to the amount standing to his credit at the end of the year in which he retires.

(3) The payment, to the personal representatives of a member who dies in the service, of the amount standing to his credit at the *end* of the year in which the *death occurs.*

(4) The payment to a contributor who leaves for any reason other than age or infirmity, of the amount of his contributions up to the time he leaves and interest thereon credited up to end of the *preceding* year; and the transfer of the balance on the account of such a member to the Stabilization Account.

(5) The interest earned in each year to be credited to the individual members' accounts and the Annuity Fund in proportion to the balances thereof at the *beginning* of the year.

(6) Fluctuations in the value of investments to be ignored, but profits and losses realized to be carried to the Stabilization Account.

(7) The actuarial valuation of current annuities every three years and a transfer from (or to) the Stabilization Account to (or from) the Annuity Fund of the amount, if any, by which the valuation exceeds or is less than the Annuity Fund.

(8) A supplementary contribution to the Stabilization Account of the amount, if any, required by that account to enable any necessary transfer to be made to the Annuity Fund.

The Trial Balance of the scheme at 31st December, 19. . is—

	£	£
Contributors' Accounts (1st January, 19. .)		121,000
Annuity Fund		11,000
Contributions of Employer and Members		13,388
Investments (value at 31st December, 19. ., £145,221)	144,000	
Balance at Bank	4,989	
Interest		4,752
Profit on Realization of Investments		109
Payments to Annuitants	1,260	
	£150,249	£150,249

A valuation as on 31st December, 19. ., showed the liability for current annuities to be £12,600.

The credit balances included in Contributors' Accounts on 1st January, 19. . and members' contributions during the year of (i) members who became entitled to annuities; (ii) members who died in the service and; (iii) members who left the service for reasons other than age or infirmity were—

	Balances, 1st January, 19. .	*Members' Contributions during Year*
	£	£
(i)	1,550	30
(ii)	640	32
(iii)	880	48

No payments had been made in respect of (ii) or (iii) by the end of the year. Prepare the draft Annual Accounts of the scheme for the year ended 31st December, 19. ., and Balance Sheet as at that date. Ignore Tax and make calculations to nearest £.

Dr. CONTRIBUTORS' ACCOUNT *Cr.*

			£	£				£
19. . Dec. 31	To Annuity Fund for retired Members:				19. . Jan. 1	By Balance	b/d	121,000
	Bal., 1st Jan., 19.		1,550		Dec. 31	,, Contributions		13,388
	Interest (3·6%)		56			,, Interest (3·6%)		4,356
	Contributions during year		60	1,666				
	,, Deceased Members: Bal., 1st Jan., 19.		640					
	Interest (3·6%)		23					
	Contributions during year		64	727				
	,, Ex-employee Members: Contributions during year		48					
	Bal., 1st Jan., 19.		440	488				
	,, Stabilization A/c: Interest on £880 (3·6%)			32				
	Employer's Contributions			488				
	,, Balance	c/d		135,343				
				£138,744				£138,744
					19. . Jan. 1	By Balance	b/d	135,343

Dr. ANNUITY FUND **Cr.**

19..			£	19..			£
Dec. 31	To Cash—Annuitants .		1,260	Jan. 1	By Balance. . .	b/d	11,000
	„ Balance per Valuation . . .	c/d	12,600	Dec. 31	„ Interest, 3·6% .		396
					„ Transfer from Contributors' Accts. .		1,666
					„ Transfer from Stabilization Account.		798
			£13,860				£13,860
				19.. Jan. 1	By Balance. . .	b/d	12,600

Dr. STABILIZATION ACCOUNT **Cr.**

19..			£	19..			£
Dec. 31	To Transfer to Annuity Fund		798	Dec. 31	By Profit on Sale of Investments . . .		109
					„ Transfers from Contributors' Accounts .		520
					„ Employer's Supplementary Contributions (due) . .		169
			£798				£798

BALANCE SHEET AT 31ST DECEMBER, 19..

		£		£
Contributors' Accounts .		135,343	Investments (Market value, £145,221) . . .	144,000
Annuity Fund (per Valuation)		12,600	Employer— Supplementary Contributions . . .	169
Creditors— Deceased Members	£727		Cash at Bank . . .	4,989
Ex-employee Members . . .	488			
		1,215		
		£149,158		£149,158

Note. There are three calls on the Fund—

(*a*) An annuity to each normally retiring member (the main object of the scheme);

(*b*) A payment out to the representatives of each deceased member, not an annuity, but a lump sum cash payment;

(*c*) A payment out to an employee who leaves his employment (otherwise than by age or infirmity).

Obviously the least advantage will be to members of Class (*c*), who have returned to them (with interest) only their *own* contributions.

Clearly, the Annuity Fund dealing with class (*a*) must be administered on strict lines (hence the necessity for a periodic revaluation of the liability for current annuities); the Contributors' Accounts will be used for dealing with classes (*b*) and (*c*) without affecting the Annuity Fund; as to new liabilities under class (*a*), these must be credited to the Annuity Fund (swelling the opening balance), the *actual* payments of annuities being debited against the Fund. The balance of this Fund will, pending the revaluation, be carried forward to the succeeding year.

On the revaluation, it may be that the balance is not adequate to meet the liabilities for current annuities, and therefore in case it is not (as in the question), a draft has to be made upon the Stabilization Account (in effect, a

Suspense Account). If the Fund exceeds the liability, the benefit is carried to the Stabilization Account. The Stabilization Account is built up by special gains and the amount of the employer's contributions not repaid when members leave (Class (*c*)); but this account itself may prove insufficient to meet any draft on it for the Annuity Fund, hence calling for a supplementary contribution from the employer.

The Interest is £4,752, which is 3·6 per cent on the opening balances of the Contributors' Accounts and Annuity Fund (i.e. £121,000 + £11,000=£132,000) calculated as follows—

$$\frac{4,752}{132,000} \times 100 = \frac{4,752}{1,320} = \frac{198}{55} = 3{\cdot}6\%$$

Interest to Class (*a*), 3·6% × £1,550 = £56

Interest to Class (*b*), 3·6% × £640 = £23.

The Contributors' Account is a "total" account and there would be separate accounts for each contributor.

Solicitors' Accounts. From the examination point of view this subject may be dealt with under three heads, viz.—

(1) Treatment of Uncompleted Work.
(2) Disbursements for Clients.
(3) Segregation of Clients' moneys.

(1) The work that is on hand is analogous to Work-in-Progress in Manufacturing Accounts and will be incorporated into the accounts by a credit to Costs or Fees Account, brought down as a balance and shown in the Balance Sheet as an Asset, unless the Debtors and Uncompleted Work are eliminated by 100 per cent Reserve or Provision to reduce *earned* profits to *cash* profits.

(2) Disbursements. There are two methods in use, viz.—

(i) Upon payment, the amount is entered on the credit side of the Cash Book and debited *direct* to the client on whose behalf the outlay was made. The disbursements, therefore, in this method merely become merged in the debit balances of the clients and will not appear further as a distinctive item.

(ii) The payments made for clients are debited to a Disbursements Account. The charge to the client in respect of a disbursement on his behalf will not be made till the Bill of Costs is rendered to him, when the disbursement charge will be added to the bill.

In system (ii) the Costs Book, Bills Delivered Book, or Bill of Costs Journal (being the alternative descriptions for the book in which outgoing invoices are entered) will be ruled with the usual columns for dates, etc., and three main columns (1) Costs (or Fees), (2) Disbursements, and (3) Total. The postings to the clients will be made from the Total column and after columns (1) and (2) have been added, the total thereof will be posted to the *credit* of Costs (or Fees) and Disbursements Account respectively.

In the ordinary course of events, there will be no recoupment for outlay for clients until (at the earliest) the Bills of Costs have been rendered to the client. The balance on Disbursements Account will

be shown in the Balance Sheet as an Asset, being disbursements not yet charged, but recoverable from clients.

Alternatively in method (ii) a Disbursements Ledger is opened and the disbursements debited therein against the client for whom the payment is made—an account being opened for each client. When the Bills of Costs are rendered, the amounts recoupable in the Bills will be dealt with in the Costs Book as mentioned (and the postings made from the Disbursements column of the Day Book to the credit of the clients' accounts in the Disbursements Ledger), or the total may be posted to the credit of Disbursements Account (precisely as mentioned) and transfers made from the clients' accounts in the Disbursements Ledger to the debit of Disbursements Account.

Where small sums are paid for clients, e.g. sundry postages, stationery, if the clients are to bear the cost of them it is necessary to debit Disbursements Account and credit the nominal account, thus reducing the ultimate charge to Profit and Loss Account. Alternatively, an additional column may be utilized in the Costs Book for sundry payments and the total thereof posted at the end of the accounting period to the credit of sundry payments accounts. (See Illustration on page 1299.)

It may be mentioned that it is usual to describe the "all in" charge as *costs*, but the charge purely for work done as *profit costs*.

(3) Segregation of Clients' moneys.

Under the Solicitors Act, 1933, Sect. 1, and the Solicitors' Accounts Rules, 1945, and the Solicitors' Trust Accounts Rules, 1945, made thereunder, rules are laid down for the keeping of clients' moneys separate from a solicitor's own moneys.

Thus, every solicitor in practice must keep such books and accounts as may be necessary to show all his dealings with (i) clients' moneys held and received from and paid to them, and (ii) any other money dealt with by him through a client's account; and to distinguish such moneys held, received or paid by him on account of each *separate* client and to distinguish such money from *other* moneys held, received or paid by him on any other account.

The rules are somewhat elaborate, but briefly they require that—

(1) Moneys received from and paid to (or on behalf of) each client be distinguished from

(2) Moneys received and paid on the solicitor's own account.

(3) Clients' moneys must be dealt with through a *separate* banking account in the name of the solicitor and the word "client" specifically employed in connection with that account.

(4) Apart from recouping costs and disbursements, such account can only be dealt with for the proper utilization of the client's money by payment to him or on his behalf or on his instructions and the withdrawal must not *exceed* the amount attributable to that client.

Several exceptions occur for correcting receipts and payments

inadvertently dealt with in or through the wrong account, and any client can make an agreement with his solicitor to dispense with the necessity of keeping intact his moneys, but if such moneys (in pursuance of this agreement) are, in fact, paid into the Clients' Banking Account, they must be regarded as belonging to that particular client and *no other*.

To that end it is necessary to keep and write up a separate banking account for dealings in clients' moneys in the name of the solicitor, specifically designated Client Account, although it is not necessary to open a separate cash book. For this purpose, a solicitor must not treat himself as a client of himself or his firm. Thus, two Bank accounts will be employed—own and clients, or office and clients.

Only clients' moneys may be paid into the Clients' Account and withdrawn only for proper payments made to or on behalf of clients and for correction of any error in paying inadvertently to Clients' Account (e.g. amounts covering fees) and for withdrawal of moneys paid in to the bank for the purpose of opening the account: but in all cases there can be no withdrawal from Clients' Banking Account of a sum exceeding the amount standing to the *credit* of a particular client for the object is to keep intact in Clients' Banking Account the exact sum necessary to discharge immediately all balances due to clients. Therefore, it is not sufficient merely to have in the Clients' Banking Account the sum equal to the total of Clients' accounts unless *all* are in credit. If a solicitor, for simplicity of illustration, has three clients A, B and C whose balances are A (Dr) £10, B (Cr) £2 and C (Cr) £12, the amount of net indebtedness is £4, but the amounts in credit are £14 and this is the figure required in the Clients' Banking Account. The solicitor cannot withdraw from Clients' Banking Account, e.g. more than £2 for fees and for disbursements on B's account, because if he did he would be using some of C's money.

Hence it is insufficient compliance with the Rules merely to have in Clients' Banking Account sufficient to meet the "net" Clients' balances, that is the excess of the credit balances over the debit. In other words, the transfer from Clients' Bank to own Bank is permissible only to the extent that it does not *exceed* a particular client's money.

Subject to the rule above-mentioned, a solicitor will recover his fee and outlay chargeable to a client by debiting own (or office) Bank and crediting Clients' Bank, but only in so far as it represents that particular clients' money. If the credit balance of the client is insufficient to meet the fee and outlay it will be necessary for him to pay in the ordinary way, whereupon the receipt will be dealt with by the solicitor by debiting own (or office) Bank and crediting the client.

Two Column Ledger Method. Two columns are employed on each side of the ledger corresponding with those in the Cash Book, i.e. "Office" and "Clients," and all records for and against clients are

made in "Office," except those which must relate to the Clients' column in the Cash Book i.e.—

(1) Receipts from or on behalf of clients, except for costs and disbursements.

(2) Payments to, or on behalf of clients out of clients' moneys.

(3) Transfers of money in Bank in clients' column for discharge of costs and disbursements (or so far as such money belonging to the particular client will permit).

When the transfer is made, it is just as if the client literally withdrew the money and then handed it back to the solicitor in settlement of costs and disbursements, i.e.—

(1) Debit Client (Client column) Credit Bank (Client column).

(2) Debit Bank (Office column) Credit Client (Office column).

Care must be taken to debit Fees against Clients in the Office column (*not* Clients' column).

This procedure will have the advantage of proving in "total" the correspondence of the balances due to clients with the cash at bank (Clients column) and will result in giving a "clearance" to *one set of columns* on payment by the client or transfer of moneys in settlement of the account from bank (Clients' column).

Illustration. A solicitor has the following transactions—

Work performed per Costs Day Book—

19..		*Client*	*Amount* £
Jan.	1	X	30
	5	Y	17
	11	R	2
	14	X	4
	16	W	7
	30	S	11

Receipts—

19..

Jan. 1. X pays in £800 for purchase of property, completion taking place on 11th January and settlement (£770) by cheque on that day.

5. R pays in for general investment £600, of which the solicitor, with R's approval, invests on mortgage £550 on 25th January.

10. Solicitor collects for Safe Insurance Company premiums £46, and pays the Company on 14th January, £43, the difference being commission due to solicitor.

15. Solicitor realizes £1,200 due to estate of J deceased, of which W is the sole beneficiary, and on the 29th remits to W the balance due to him, *less* costs and disbursements (per Petty Cash Book), and after transferring to S, on instructions, £1,000, being loan on mortgage by W to S.

24. X pays his bill of £4.

30. Y pays on account. £5.

Payments (in addition to those mentioned above)—

19..

Jan. 1. Petty Cash, £20.

13. Disbursements out of clients' moneys for R, £10.

19. Petty Cash, £30.

26. Petty Cash, £20.

Petty Cash Payments—

			£
19..			
Jan.	4.	Disbursements W.	3
	12.	Disbursements Y .	2
	14.	Disbursements S .	6
	30.	Wages	21
	31.	General Expenses.	7
		Drawings	15

The opening Balances were—

	£	£
Cash at Bank—Office	720	
—Clients	160	
Fixtures	150	
Capital .		870
Clients—B		150
—Y		10
	£1,030	£1,030

Prepare accounts and draw up Trial Balance at 31st Jan., 19...

Costs Day Book

			£
19..			
Jan.	1.	X	30
	5.	Y	17
	10.	Safe Insurance Co.	3
	11.	R	2
	14.	X	4
	16.	W	7
	30.	S	11
			£74

Private Ledger

Dr. CAPITAL *Cr.*

				19.. Jan. 1	By Balance .		£ 870

Dr. FIXTURES, ETC. *Cr.*

19.. Jan. 1	To Balance .		£ 150				

Dr. GENERAL EXPENSES *Cr.*

19.. Jan. 31	To Cash.		£ 7				

Dr. WAGES *Cr.*

19.. Jan. 31	To Cash.		£ 21				

Dr. DRAWINGS **Cr.**

			£				£
19.. Jan. 31	To Cash . . .		15				

Dr. COSTS (FEES) **Cr.**

			£				£
				19.. Jan. 31	By Sundrie . .		74

Clients' Ledger

Dr. B **Cr.**

			Office	Clients				Office	Clients
					19.. Jan. 1	By Balance . .			£ 150

Dr. Y **Cr.**

			Office	Clients				Office	Clients
19..			£	£	19..			£	£
Jan. 5	To Costs		17		Jan. 1	By Balance .	b/d		10
	,, *Cash—Transfer*			10	5	,, *Cash—Transfer*		10	
12	,, Disbursements .		2		30	,, Cash on account		5	
					31	,, Balance .	c/d	4	
			£19	£10				£19	£10
Feb. 1	To Balance . .	b/d	4						

Dr. X **Cr.**

			Office	Clients				Office	Clients
19..			£	£	19..			£	£
Jan. 1	To Costs . .		30		Jan. 1	By Cash .			800
	,, *Cash—Transfer* .			30		,, *Cash—Transfer* .		30	
	,, Settlement . .			770	24	,, Cash . .		4	
14	,, Costs . . .		4						
			£34	£800				£34	£800

Dr. R **Cr.**

			Office	Clients				Office	Clients
19..			£	£	19..			£	£
Jan. 11	To Costs . . .		2		Jan. 5	By Cash . .			600
13	,, Disbursements .			10	25	,, *Cash—Transfer* .		2	
25	,, Cash—Mortgage .			550					
	,, *Cash—Transfer* .			2					
31	,, Balance .	c/d		38					
			£2	£600				£2	£600
					Feb. 1	By Balance . .	b/d		38

W

Dr.			Office	Clients		Cr.		Office	Clients
19..			£	£	19..			£	£
Jan. 4	To Disbursements		3		Jan. 15	By Cash			1,200
16	,, Costs		7		29	,, *Cash—Transfer*		10	
29	,, Transfer to S on Mortgage [See Note at end]			1,000					
	,, *Cash—Transfer*			10					
	,, Cash—Settlement			190					
			£10	£1,200				£10	£1,200

S

Dr.			Office	Clients		Cr.		Office	Clients
19..			£	£	19..			£	£
Jan. 14	To Disbursements		6		Jan. 29	By Transfer from W on Mortgage			1,000
30	,, Costs		11		30	,, *Cash—Transfer*		17	
	,, *Cash—Transfer*			17					
31	,, Balance	c/d		983					
			£17	£1,000				£17	£1,000
					Feb. 1	By Balance	b/d		983

Safe Insurance Co., Ltd.

Dr.			Office	Clients		Cr.		Office	Clients
19..			£	£	19..			£	£
Jan. 10	To Costs		3		Jan. 10	By Cash			46
14	,, *Cash—Transfer*			3	14	,, *Cash—Transfer*		3	
	,, Cash			43					
			£3	£46				£3	£46

Cash Book (Bank)

Dr.			Office	Clients		Cr.		Office	Clients
19..			£	£	19..			£	£
Jan. 1	To Balance	b/d	720	160	Jan. 1	By Petty Cash		20	
	,, *X—Transfer*		30			,, *X—Transfer*			30
	,, X			800		,, X—Settlement			770
5	,, R			600	5	,, *W—Transfer*			10
	,, *Y—Transfer*		10		13	,, R			10
10	,, Safe Insurance Co.			46	14	,, *Safe Insurance Co. Transfer*			3
14	,, *Safe Insurance Co.: Transfer*		3			,, Safe Insurance Co. Settlement			43
15	,, W			1,200	19	,, Petty Cash		30	
24	,, X		4		25	,, R—Mortgage			550
25	,, *R—Transfer*		2			,, *R—Transfer*			2
29	,, *W—Transfer*		10		26	,, Petty Cash		20	
30	,, *S—Transfer*		17		29	,, *W—Transfer*			10
	,, Y on account		5			,, W—Settlement			190
					30	,, *S—Transfer*			17
					31	,, Balances	c/d	731	1,171
			£801	£2,806				£801	£2,806
Feb. 1	To Balances	b/d	731	1,117					

Dr. PETTY CASH BOOK *Cr.*

					Total	Expenses[1]	Drawings	Fol.	Ledger
19..		£	19..		£	£	£		£
Jan. 1	To Cash .	20	Jan. 4	By W . . .	3				3
19	,, Cash .	30	12	,, Y . . .	2				2
26	,, Cash .	20	14	,, S . . .	6				6
			30	,, Wages .	21	21			
			31	,, General Expenses .	7	7			
				,, Drawings .	15		15		
					54	£28	£15		£11
				,, Balance c/d .	16				
		£70			£70				
Feb. 1	To Balance b/d	16							

Dr. TRIAL BALANCE, 31ST JANUARY, 19. *Cr.*

	Office	Clients		Office	Clients
	£	£		£	£
Clients' Ledger—			Clients' Ledger—		
Y	4		B . . .		150
Bank . . .	731	1,171	R . . .		38
Petty Cash . .	16		S		983
Private Ledger—			Private Ledger—		
Fixtures . .	150		Capital . . .	870	
Drawings . .	15		Costs . . .	74	
Wages . . .	21				
General Expenses .	7				
	£944	£1,171		£944	£1,171

Notes. (i) The transfer from W to S (£1,000) may be made through the Journal or Cash Book (on each side, Clients' column).

(ii) A separate Trial Balance exists for each column—Office and Client.

(iii) In addition, a Total Clients' Ledger Account may be built up.

Where it is desired to know at any time what is due to clients, this may be achieved by several methods the most important of which are—

(1) *Double Column Method.* The procedure is—

(*a*) The Clients' Ledger, Office Cash and Bills Delivered book will all be ruled with two columns (own and clients).

(*b*) Payments made for and fees charged to clients *who have cash on hand* will be entered in the Clients' column of the Office Cash and Bills Delivered books.

(*c*) Where cash is received from a client for whom payments have been made out of office moneys, it should be split up between clients' and office monies, accordingly.

Thus the balance at Bank (Clients' column), less the total of payments shown in Clients' column of Office Cash, and the total of Fees

[1] Analysed columns for each main type of expenditure.

entered in the Clients' column of Bills Delivered Book will equal the Clients' Ledger *credit* balances.

(*d*) These totals at the end of each suitable period will be transferred from Clients' to Office columns in the Bank and Cash Accounts, and the totals of Clients' columns in the Cash and Bills Delivered Books will be extended into the main columns of these books.

Illustration. A. B. Stract commences to practise as a solicitor on the 1st January with cash capital of £2,000, the amount being paid into Office Bank Account.

The following transactions arise in January—

19..

Jan. 3. Paid by cheque £200 for Office Furniture.
Drew £100 for general cash.

5. Received £1,500 from client Porter and paid deposit of £100 for purchase of house by Porter, costing £1,000.

6. Collected insurance premiums for Insurance Co., £80, remitted next day to Company, *less* Commission of 2½ per cent.

Paid Estate Duty by cheque, £170, on account of executors of Walter, deceased.

Received Sundry Costs, banked, £4.

8. Received Sundry Costs, not banked, £1.

12. Received from National Bank, £800, being the balances standing to the credit of Walter.

13. Paid debts, etc., of Walter, deceased, £110.

14. Paid by cheque £40 deposit on purchase of house (costing £400) by Dyke.

15. Paid out of office Cash, disbursements for Lake, £6.

18. Completion of purchase of house by Porter, drawing cheque in settlement after paying duties in Cash £15 and charging costs of £18.

24. Sundry receipts for legal costs, banked £7.

31. Paid all general expenses by cash for month, £23.
Drawings by cheque, £40.

The following bills had been rendered—

		£
Jan. 15.	Lake	11
30.	Brown	13

Undelivered Costs are £90.

Write up the books and prepare Trial Balance as at, and Profit and Loss Account to, 31st January. [The records are to be such that a separate Trial Balance of clients' moneys can be extracted at once.]

Cash Book (Bank)

Dr.

Date			Clients	Office
19..			£	£
Jan. 1	To A. B. Stract—Capital			2,000
5	" Porter		1,500	
6	" Insurance Co. Premiums		80	
	" Sundry Costs			4
12	" Exors. of Walter, deceased—Transfer of Balances: Reimbursement of Estate Duty paid			170*
	Balance		630	
24	" Sundry Costs			7
31	" Transfer *per Contra*			35*
			£2,210	£2,216
Feb. 1	To Balances	b/d	520	1,666

* See note 2 on page 1301

Cr.

Date			Clients	Office
19..			£	£
Jan. 3	By Office Furniture			200
	" Office Cash			100
5	" Porter: Deposit on Purchase of House		100	
6	" Exors. of Walter, deceased: Estate Duty			170
7	" Insurance Co.: Premiums Collected £80 *Less* 2½% Commission 2		78	
13	" Exors. of Walter, deceased: Debts, etc.		110	
14	" Dyke: Deposit on Purchase of House			40
18	" Porter: Balance of Purchase Price of House		900	
	" Porter: Balance of account . £500 *Less* Costs 18 " Duties 15 — 33		467	
31	" Drawings			40
	" Transfer to Office Bank: Payments from Cash		15	
	Bills delivered		20	
	" Balances	c/d	520	1,666
			£2,210	£2,216

Office Cash

Dr.

Date				£
19..				
Jan. 3	To Cash from Bank			100
8	" Sundry Costs			1
				£101
Feb. 1	To Balance	b/d		57

Cr.

Date			£	£
19..				
Jan. 15	By Lake—Disbursements			6
18	" Porter		15	15
31	" General Expenses			23
	" Balance	c/d		57
				£101

CLIENTS' LEDGER

Executors of Walter, Deceased

Dr.

Date			Clients	Office
19..			£	£
Jan. 6	To Estate Duty paid			170
13	" Debts, etc., paid		110	
31	" Balance	c/d	520	
			£630	£170

Cr.

Date			Clients	Office
19..			£	£
Jan. 12	By National Bank		630	170
			£630	£170
Feb. 1	By Balance	b/d	520	

Dr. **Porter** *Cr.*

			Clients	Office				Clients	Office
19..			£		19..			£	
Jan. 5	To Deposit: Cheque paid to Vendor, 10% of Purchase Price of House of £1,000 . .		100		Jan. 5	By Cash . . .		1,500	
18	" Cheque: Balance of Purchase price		900						
	" Cash Disbursem'ts.		15						
	" Costs . . .		18						
	" Cheque settlement		467						
			£1,500					£1,500	

Dr. **Insurance Company** *Cr.*

			Clients	Office				Clients	Office
19..			£		19..			£	
Jan. 7	To Cheque—Settlement .		78		Jan. 6	By Premiums rec'ved		80	
	" Costs . . .		2						
			£80					£80	

Dr. **Dyke** *Cr.*

			Clients	Office				Clients	Office
19..				£					
Jan. 14	To Deposit: Cheque paid to Vendor, 10% of Purchase Price of House, £400. . .			40					

Dr. **Lake** *Cr.*

			Clients	Office				Clients	Office
19..				£					
Jan. 15	To Cash—Disbursements .			6					
	" Costs . . .			11					

Dr. **Brown** *Cr.*

			Clients	Office				Clients	Office
19..				£					
Jan. 30	To Costs . . .			13					

NOMINAL LEDGER

Capital

Dr.			£	Cr.			£
19.. Jan. 31	To Cheque		40	19.. Jan. 1	By Cash		2,000
	,, Balance	c/d	2,083	31	,, Profit		123
			£2,123				£2,123
				Feb. 1	By Balance	b/d	2,083

Office Furniture

Dr.			£	Cr.			
19.. Jan. 3	To Cheque—Purchases		200				

General Expenses

Dr.			£	Cr.			£
19.. Jan. 31	To Cash		23	19.. Jan. 31	By Profit and Loss A/c		23

Costs Account

Dr.			£	Cr.			£
19.. Jan. 31	To Profit and Loss A/c		146	19.. Jan. 6	By Cash—Costs		4
				8	,, Cash—Costs		1
				24	,, Cash—Costs		7
				31	,, Sundries per Bills Delivered Book		44
					,, Undelivered Costs	c/d	90
			£146				£146
Feb. 1	To Undelivered Costs	b/d	90				

Bills Delivered Book

			£	£
19.. Jan. 7	Insurance Co.—Commission		2	
15	Lake			11
18	Porter—Conveyance		18	
30	Brown			13
			£20	20
				£44

Trial Balance, 31st January, 19.

		£	£
Capital			1,960
Office Furniture		200	
Costs			56
General Expenses		23	
Office Bank		1,666	
Office Cash		57	
Clients' Bank		520	
Clients' Balances—			
Dyke		40	
Lake		17	
Brown		13	
Walter			520
		£2,536	£2,536

PROFIT AND LOSS ACCOUNT
FOR THE MONTH ENDED 31ST JANUARY, 19..

Dr.	£		Cr.	£
To General Expenses . .	23		By Costs (£44+£12+£90) .	146
„ Profit to Capital . .	123			
	£146			£146

BALANCE SHEET AT 31ST JANUARY, 19..

	£	£		£	£
Capital Introduced .	2,000		Office Fixtures . .		200
Less Drawings .	40		Undelivered Costs .		90
			Sundry Debtors (Clients)		
	1,960		[£40 + £17 + £13] .		70
Add Profit . .	123		Cash at Bank—		
		2,083	Clients . . .	520	
Clients' Balances .		520	Office . . .	1,666	
					2,186
			Office Cash . . .		57
		£2,603			£2,603

(2) *Control Accounts Method.* This method requires the opening of two reciprocal accounts, viz. —

(*a*) Clients' Ledger Control Account in the Nominal Ledger and,

(*b*) Nominal Ledger Control Account in the Clients' Ledger.

The procedure is—

(1) All disbursements made on behalf of clients out of solicitor's own moneys—Bank and/or Cash, and all costs charged to clients will be debited to Clients' Ledger Control and credited to Nominal Ledger Control Account.

(2) At intervals, a clearance of these accounts will be made so as to leave the balances on the reciprocal accounts equal to the *debit* balances against Clients, and at the same time similar transfers will be made in the Bank Accounts, thus involving the ascertainment of the balancing figure and the making of the following entries—

(i) Debit Nominal Ledger Control Account and credit Clients' Bank Account.

(ii) Debit Office Bank Account and Credit Clients' Ledger Control Account.

Illustration. Using the same facts as in the preceding illustration write up the Control Accounts; and prepare Trial Balance.

CLIENTS' LEDGER CONTROL ACCOUNT (in Nominal Ledger)

19..			£	19 .			£
Jan. 6	To Walter—Cash . .		170	Jan. 31	By Transfer to Office Bank . . .		205
7	„ Insurance Co.—Costs .		2		„ Balance . . .	c/d	70
14	„ Dyke—Cash . .		40				
15	„ Lake—Cash . .		6				
	„ Porter—Cash . .		15				
	„ Lake—Costs . .		11				
18	„ Porter—Costs . .		18				
30	„ Brown—Costs . .		13				
			£275				£275
Feb. 1	To Balance . . .	b/d	70				

[Followed by reciprocal account in Clients' Ledger headed Nominal Ledger Control Account, with items on reverse sides, showing net credit balance of £70.]

NOMINAL LEDGER TRIAL BALANCE, 31ST JANUARY, 19..

	£	£
Capital		1,960
Office Furniture	200	
Costs (Cash, £12; Clients, £44)		56
General Expenses	23	
Clients' Ledger Control Account	70	
Office Bank	1,666	
Office Cash	57	
	£2,016	£2,016

CLIENTS' LEDGER TRIAL BALANCE, 31ST JANUARY, 19..

	£	£
Walter		520
Dyke	40	
Lake	17	
Brown	13	
Clients' Bank	520	
Nominal Ledger Control Account		70
	£590	£590

Notes (1). It will be seen that eliminating the reciprocal items of £70, the resulting Trial Balance is the same as in the preceding illustration. The final accounts will be as in the preceding illustration, after adjusting £90 for undelivered costs.

(2) The transfer of £205 in the Control Account corresponds with the total of the entries in the preceding illustration of £170 and £35. (See items marked * on page 1297.)

Illustration. P. Leader, a solicitor, submits to you the following figures extracted from his books at 31st December, 19...

	£
P. Leader (credit)	1,250
Rent	250
Salaries	1,000
Amounts received from Clients on account of matters pending	615
Sundry amounts owing (credit)	25
Office Expenses	560
Furniture and Library	650
Amounts owing by Clients for Bills of Costs delivered	820
Clients' Disbursements	317
Bank (Clients) (debit)	550
Bank (Office) (debit)	820
Profit Costs	3,077

Disbursements specifically made for clients are debited to a general Clients' Disbursements Account. The Bill Book is ruled with three columns for Profit Costs, Clients' Disbursements, and Total. Each item in the Total column is posted to the debit of the respective client's account, and each month the totals of Profit Costs and Clients' Disbursements columns are posted to the credit

of Profit Costs Account and Clients' Disbursements Account respectively. Included in the Bills of Costs sent to clients are sundry small disbursements, e.g. postages, debited in the books to Office Expenses Account.

On 31st December, 19.., items on the debit side of Clients' Disbursements Account amounting to £387 had not been charged to Clients in Bills of Costs. Of this amount £15 had been received from clients and credited to their accounts.

Prepare Profit and Loss Account for the year ended 31st December, 19.., and Balance Sheet at that date.

PROFIT AND LOSS ACCOUNT FOR THE YEAR ENDED 31ST DECEMBER, 19..

Dr. | *Cr.*

		£			£
To Rent		250	By Profit Costs		3,077
,, Salaries		1,000			
,, Office Expenses		490			
,, Net Profit to Capital Account		1,337			
		£3,077			£3,077

BALANCE SHEET AS AT 31ST DECEMBER, 19..

	£	£		£	£
Capital Account—			Furniture and Library		650
Balance 1st Jan., 19..	1,250		Debtors for Costs Rendered	820	
Add Net Profit from Profit and Loss Account	1,337		Clients' Disbursements Account	372	
		2,587			1,192
			Cash at Bank—		
Sundry Creditors		25	Own	820	
Clients' Accounts		600	Clients	550	
					1,370
		£3,212			£3,212

Notes. (*a*) No amount is shown for Drawings.

(*b*) The credit balances on Clients' Accounts should agree with the appropriate Bank balance.

(*c*) A transfer is necessary to the extent of £70 representing small disbursements—at present appearing in Office Expenses Account—making the total chargeable disbursements £387.

(*d*) The item £15, as indicated in the question, has been received already in payment of disbursements, so that a transfer is necessary to adjust the position.

The foregoing transfers are—

		£	£
(i) Clients' Disbursements Account . . *Dr.*		70	
To Office Expenses			70
(ii) Clients' Accounts . . *Dr.*		15	
To Clients' Disbursements Account			15

Clients' Disbursements Account will now appear as follows—

CLIENTS' DISBURSEMENTS ACCOUNT

Dr. | *Cr.*

		£			£
To Balance (per T.B.)		317	By Clients' Accounts		15
,, Office Expenses		70	,, Balance	c/d	372
		£387			£387
To Balance	b/d	372			

The use of the single column (although not recommended) is shown below.

Illustration. The following is a schedule of balances of a solicitor at 1st January, 19..—

	Dr.		*Cr.*
	£	£	£
Bank (Office)	350		
Bank (Clients)	620		
Clients' Accounts—A		120	
B		160	
C		40	
D		300	620
E	15		
Sundry Assets	100		
Capital			465
	£1,085		£1,085

From the above, and from the following details, write up the books and prepare Trial Balance. Ignore Drawings and Expenses.

(1) Received from D £150 to be later invested on instructions.

(2) Work done for Clients: A, £70; B, £120; C, £85; D, £10; E, £30; F, £17—Total, £332

(3) Disbursements for A, £30; B, £65; C, £15.

(4) D agrees to lend to E £100 on Mortgage, the Solicitor *transferring* such sum to E.

(5) B pays the balance of his account; C, £30 on account.

Dr. LEDGER ACCOUNTS *Cr.*

		A	B	C	D	E	F			A	B	C	D	E	F
		£	£	£	£	£	£			£	£	£	£	£	£
To Balance	b/d					15		By Balances	b/d	120	160	40	300		
,, Disbursements .		30	65	15				,, Cash .					150		
								,, *Transfer*						*100*	
,, Costs .		70	120	85	10	30	17	,, Cash .			25	30			
,, *Transfer*					*100*			,, Balances	c/d			30			17
,, Balances	c/d	20			340	55									
		£120	£185	£100	£450	£100	£ 17			£120	£185	£100	£450	£100	£ 17
[1] To Balances	b/d			30			17	By Balances	b/d	20			340	55	

Dr. BANK *Cr.*

		Office	Clients			Office	Clients
		£	£			£	£
To Balances . .	b/d	350	620	By Disbursements—			
,, D . . .			150	A			30
,, *Transfers from Clients' Bank*—				B			65
				C			15
A . . .		*70*		,, *Transfers to Office Bank*—			
B . . .		*195*		*A*			*70*
C . . .		*25*		*B*			*195*
D . . .		*10*		*C*			*25*
E . . .		*45*		*D*			*10*
,, B		25		*E*			*45*
,, C		30		,, Balances . .	c/d	650	415
		£650	£770			£650	£770
To Balances . .	b/d	650	415				

[1] See footnote on page 1304.

Trial Balance	Dr.	Cr.
	£	£
Bank (Office)	650	
Bank (Clients)	415	
Clients' Accounts (as on page 1303)	47	415
Sundry Assets	100	
Capital		465
Costs (per Costs Book)		332
	£1,212	£1,212

BUILDING SOCIETIES' ACCOUNTS

Building Societies are bodies formed for the purpose of raising funds to be employed in making advances of money to members to assist them in acquiring freehold or leasehold property, such property forming the security for the advances.

Most Building Societies are bodies corporate formed under the Building Societies Acts, 1874 and 1894, and to a certain extent controlled by the Registrar of Friendly Societies.

The members, therefore, are (*a*) investors and (*b*) borrowers and the interest charged to the latter will exceed that granted to the former, thus forming the main source of income out of which the society meets its expenses. Over a period of years the main Building Societies have accumulated large reserves, the income on which forms a considerable portion of their yearly revenue.

The published accounts of Building Societies are in the form laid down by the Registrar of Friendly Societies and in practice follow the form set out in the Schedule to the Building Societies Act, 1894, with certain recent modifications.

The main headings are—

(1) Receipts and Payments Account;
(2) Revenue and Expenditure Account;
(3) Liabilities and Assets Account.

Certain details are required in connection with mortgages; and certain mortgages must be excluded in arriving at the statutory borrowing limits of a Building Society (not to exceed two-thirds of the amount secured to the society by "active" mortgages); the latter are all mortgages *other* than those which must be shown in the following schedules—

(1) Mortgages where the repayments are not upwards of twelve months in arrears and where the property has not been upwards of twelve months in possession of the Society and where the present debt exceeds £5,000.

[1] £95 is the maximum sum *transferable* in respect of Costs because the credit balance of B's account is that sum only [£160 *less* £65], so that were the Solicitor to transfer a greater sum he would be utilizing other clients' balances.

All transfer items are in italics.

(2) Property in possession of the Society for upwards of twelve months.

(3) Mortgages where the repayments are in arrear for upwards of twelve months and the property has not been in the possession of the Society for upwards of twelve months.

Receipts and Payments Account. This is a summarized copy of the Cash Book of the Society.

Revenue and Expenditure Account. This is made up of five sub-accounts: a Shareholders' Account, Deposit and Loan Account, Mortgages Account, Profit and Loss Account, and Appropriation Account.

Liabilities and Assets Account. This is the equivalent of the Balance Sheet of a trading concern and is set out in skeleton form. It is headed "*Dr*" and "*Cr*" with the prefix "*To*" on the left-hand or "*Dr*" side and "*By*" on the right hand or "*Cr*" side.

The following points should be noted—

(1) The liabilities to shareholders, depositors and loan creditors are shown separately from the interest accruing thereon, the total liability being extended into the main column.

(2) Each class of Shareholding is shown separately and the combined figure extended into the main column.

(3) Liabilities to Depositors are similarly subdivided (and extended) according to the terms of repayment.

(4) The remaining items on the liabilities' side of the "Account" comprise the undivided profits, general reserves and reserves or funds for specific purposes, separately shown and the total extended into the main column.

(5) The main and first asset item is "Balances due or outstanding on Mortgage Securities" and is classified as laid down by the Building Societies' Act 1894.

Separate totals appear as to Mortgages on property of which the Society has been in possession for upwards of twelve months or when repayments are upwards of twelve months in arrear.

(6) The next item is the Investments held, classified according to the Building Society Act, 1894.

(7) The next item is Premises and other assets, except the above and (8).

(8) Lastly, separate inset amounts for Cash on hand and Cash at Bankers, the aggregate of which is extended into the main column.

Illustration. From the following Trial Balance of the Manford Building Society prepare Profit and Loss Account, Revenue Account, and Liabilities and Assets Account.

TRIAL BALANCE, 31ST DECEMBER, 19..

	£ Dr.	£ Cr.
Management Expenses	65,105	
Interest on Deposits and Loans—		
Deposits	25,560	
Home Safes	628	
Bank Commission	394	
Income Tax	99,591	
Profits Tax	4,906	
Staff Superannuation Fund	734	
Amounts written off Mortgages	1,650	
Insurance Commission		6,634
Interest from Borrowers		320,608
Interest and Dividends from Investments		40,446
Rents Receivable (Office Premises)		3,015
Sundry Fees, Fines, etc.		910
Subscription Shares Interest	127,524	
Paid-up Shares Interest	24,450	
Profit on Sale of Securities		6,080
Profit on Sale of Property		147
Property and Contents	60,772	
Balance Due or Outstanding on Mortgages	8,687,665	
Investments	1,803,054	
Balances at Bankers and on hand	249,993	
Due to Shareholders, including Interest—		
Subscription Shares		6,854,884
Paid-up Shares		1,461,509
Creditors for Deposits: Home Safe and Loans		1,903,229
Other Liabilities		74,824
General Reserve		420,000
Contingencies Reserve		43,021
Appropriation Account		16,719
	£11,152,026	£11,152,026

Provide for accrued interest on investments £9,602; transfer £30,000 to General Reserve; write off £1,050 from the Society's Property and Contents.

MANFORD BUILDING SOCIETY

STATEMENT OF ACCOUNTS FOR THE YEAR ENDED 31ST DECEMBER, 19..
(*Abridged*)

Dr. 5. PROFIT AND LOSS ACCOUNT *Cr.*

Expenditure	£	*Income*	£
Management Expenses	65,105	Interest from Borrowers	320,608
Interest on Deposits and Loans—		Interest from Investments	50,048
Deposits	25,560	Rents from Letting of Office Premises	3,015
Home Safes	628	Sundry Fees, Fines, etc.	910
Bank Commission	394	Commission (Fire and Life Insurance)	6,634
Income Tax	99,591		
Profits Tax	4,906		
Staff Superannuation Fund	734		
Losses on Realization and Amounts written off Mortgages	1,650		
Balance carried down to Account, No. 6	182,647		
	£381,215		£381,215

Dr. 6. APPROPRIATION ACCOUNT *Cr.*

Expenditure	£	*Income*	£
Subscription Shares Interest	127,524	Balance brought forward	16,719
Paid-up Shares Interest	24,450	Balance brought down from Account, No. 5	182,647
Amount written off Society's Properties	1,050	Profit on Sale of Securities	6,080
Transfer to General Reserve	30,000	Profit on Sale of Property	147
Balance carried forward	22,569		
	£205,593		£205,593

Dr. 7. GENERAL RESERVE ACCOUNT *Cr.*

Expenditure	£	*Income*	£
Balance at end of year	450,000	Appropriation from Account No. 6	30,000
		Balance at beginning of year	420,000
	£450,000		£450,000

Dr. 7*a*. CONTINGENCIES ACCOUNT *Cr.*

Expenditure	£	*Income*	£
Balance at end of year	£43,021	Balance at beginning of year	£43,021

8. BALANCE SHEET (Liabilities and Assets Account)

Liabilities	£	£	*Assets*	£
Due to holders of Shares, including Interest, viz.			Balance due or outstanding on Mortgages, not including prospective interest (classified under S.14, Building Societies Act, 1894, and Schedules II and III thereof)	8,687,665
Subscription Shares	6,854,884			
Paid-up Shares	1,461,509	8,316,393		
Home Safe Deposits and due to Creditors for Deposits and Loans (other than Loans from Bank) (classified)		1,903,229	Investments, including Interest accrued (classified)	1,812,656
Other Liabilities (classified)		74,824	Head and Branch Offices and Contents	59,722
Reserves—			Balances at Bankers and Cash in hand	249,993
General Reserve	450,000			
Contingencies Reserve	43,021			
Unappropriated Profits per Account No. 6	22,569	515,590		
		£10,810,036		£10,810,036

[Certificate of Auditors]

CO-OPERATIVE SOCIETY ACCOUNTS

The procedure in respect of official returns and accounts is laid down by Sect. 14 of the Industrial and Provident Societies Act, 1893 as amended by Sect. 3 of the Industrial and Provident Societies Act, 1913. Briefly stated the accounts are—

(i) *Cash Account.* This is a summary of the Cash (and Bank) transactions for the year and includes, in addition to the usual receipts and payments of a revenue nature, share receipts and repayments, Purchase and Sale of Investments, Savings Deposit transactions, etc. The balance of Cash and Cash at Bank (or Bank

overdraft) will agree with the corresponding item in the Balance Sheet.

The special requirement is, therefore, that the summary of cash transactions be published.

(ii) *General Expenses* chargeable to Trade. For practical purposes this statement is similar to an ordinary Profit and Loss Account, disclosing the usual expenses and certain income; the balance is carried to the Trade Account.

The special feature is that in ordinary accounts the Trading results are carried to the Profit and Loss Account, but here the transfer is *from* this account to the Trade Account, virtually a Trading account.

(iii) *Investments Revenue Account.* This is a special "non-trading" Income and Expenditure Account, the balance of which is carried to the Profit and Loss Account (virtually an Appropriation Account); it consists of investment and property income, less appropriate expenses (and not being Trade Expenses).

(iv) *Trade Account.* This is made up of Opening and Closing Stocks, Purchases and Sales, together with the balance of General Expenses (ii). The balance is carried to Profit and Loss Account.

(v) *Profit and Loss Account.* Virtually an Appropriation account.

(vi) *Balance Sheet.* This is in elaborate detail and the main headings are illustrated below.

An examination candidate will not be expected to know every detail of the accounts of concerns under the Industrial and Provident and the Building Societies Acts.

Illustration. Specimen Balance Sheet (in main outline) of—

BIGGDIV CO-OPERATIVE SOCIETY, LTD.

BALANCE SHEET AS AT ....

Capital and Liabilities	£	£	*Assets*	£	£
Shares, Members' Claims, Withdrawal Shares		30,000	Stock		9,000
Savings Bank Deposits		3,000	Land and Buildings used in Trade		8,500
Loans		16,000	Fixtures and Fittings used in Trade		2,700
Creditors for Goods		1,500	Plant and Machinery used in Trade		1,800
Reserves—			Rolling Stock		900
General Reserve Fund	10,000		Investments—		
Education Reserve Fund	300		Land and Buildings	1,000	
Dividend Equalization Fund	2,000		House Property	6,000	
Death Benefits Reserve Fund	1,000		Industrial and Provident Societies—		
Plate Glass Insurance Reserve Fund	400		Shares £17,000		
		13,700	Loans 3,000	20,000	
Amount appropriated for Share Interest, not yet credited to Share Capital	600		Other Securities—		
Profit Unappropriated	3,100		Shares £2,000		
		3,700	Loans 3,500	5,500	
					32,500
			Accounts owing to the Society		900
			Cash at Bank	9,600	
			Cash in hand	2,000	
					11,600
		£67,900			£67,900

[Certificate of Auditors.]

FARM ACCOUNTS

Several special features arise in farm accounts, although in practice many farmers' accounts are very crude and unreliable.

The chief points are—

(1) Separate "departmental" accounts for different activities, e.g. Dairy, Crops, Fruit and Livestock rearing (subdivided as required).

(2) Systems of transfers as in commercial activities, e.g. as in a garage. Typical are—

Debit to Wages and Credit to Rents of Cottages for rent free occupation of labourers[1];

Debit to Wages and Credit to Milk, etc. Accounts for subsistence of labourers; (and family of occupier if they assist in the farm activities)[1];

Debit to Drawings and Credit to Milk, etc. Accounts for subsistence of occupier.

Debit to various crop accounts and Credit to respective Field Accounts for cost of crops raised;

Debit to Calves Account and Credit to Cows Account for calves produced (similar for sheep, pigs, poultry).

The system of rotation of crops resulting in a number of fields lying "fallow," occasionally sown with "fallow crops," means that a number of fields are not in full production and, as there are expenses incurred in a fallow year, these are carried forward to the producing years less realization of fallow crops (if any).

Where, as is customary, many transactions are on a semi-barter or set-off system, an exchange register with supporting invoices (rarely given) is required to show the true "gross," e.g. a heifer and two pigs might be exchanged for a bull, either without cash passing at all or for a net payment or receipt.

Highly organized farms keep statistical data and registers, but the typical small farmer does not trouble to keep these, except as required by law, e.g. Milk Marketing Board, etc. and Agistment Register.

Occasionally, heavy expenditure may be incurred on seeds and fertilizers which will be spread over a period, whilst equipment will be dealt with in the usual manner.

Other special features exist, e.g. subsidies, valuation of live stock, compensation for loss in cases of destruction of animals ordered on account of disease, e.g. foot and mouth disease, cost of pest control.

Particular attention must be paid to adequate insurances, some of which are of especial importance to farmers, e.g. anthrax, loss of cattle through straying, etc. Some farmers do not (because of the high premium) insure horses, but place to Reserve a certain sum each year to cover losses.

Two technical features of farm accounting are valuation of

[1] If farm is in charge of bailiff, similar entries would be made; and also analogous entries for Heat and Light (debit Wages; credit to Farm Heat and Light Account).

livestock and manurial rights, but these are for farm valuation experts.

Illustration.

Dr. CATTLE TRADING ACCOUNT FOR THE YEAR ENDED .... *Cr.*

		No.	£	£			No.	£	£
To Opening Stock		500		4,200	By Sales		190		5,630
„ Purchases		250		2,700	„ Cattle Slaughter (Sales of Meat)		60	2,400	
„ Births . . . 69					„ Sales of Hides			420	
Less Stillborn . 3		66			„ Sales of Offal			360	
„ Foodstuffs—									3,180
Opening Stocks			80		„ Sale of Carcases		4		17
Concentrates			120		„ Closing Stock		562		[illegible]
Hay (transferred)			270						
Crop and Pasture (transferred)			520						
			990						
Less Closing Stocks			90						
				900					
„ Balance	c/d			1,027					
		816		£8,827			816		£8,827
To Labour (transferred)				190	By Balance	b/d			1,027
„ Grinding				30					
„ Repairs				40					
„ Depreciation				35					
„ Insurance				15					
„ Allocation of General Expenses				200					
„ Profit on Cattle for Year to General Profit and Loss Account				517					
				£1,027					£1,027

Notes. (1) Labour transferred—credited to Wages.

(2) Repairs, Depreciation, and General Expenses transferred—credited to the respective accounts; this should include proportion of Rent, even if farm owned by the occupier. Rent Account will be debited in the first instance with the total rent, credit landlord, if rented; if not, the credit will be to owner-occupier, with basis of a fair letting value. (In fixing this figure, regard will be had to whether the farmer as "tenant" is charged with cost of Repairs, Rates, etc.)

(3) There should be a subsidiary account, if number and size of transactions warrant it, in respect of Sales of Meat, etc., a transfer being made to the debit representing the cost of cattle slaughtered. A further subdivision of Calves, Cows, etc., could be made, a transfer being necessary to debit of Calves, credit of Cows on birth.

(4) Hay is transferred from Hay Account, except to the extent of Hay *purchased.*

(5) Insurance is either transferred from General Insurance, or, as is likely, if separate insurance, directly charged.

MONEYLENDERS' ACCOUNTS

The chief features of moneylenders' accounts are—

(1) Unless the contrary is proved, interest of more than 48 per cent per annum will be considered harsh and excessive and will not be upheld by the Court. The Court may also reopen the transaction even if the interest does not exceed this figure if it is satisfied that the interest charged is excessive (Moneylenders Acts, 1900, Sect. 1, and 1927, Sect. 10).

(2) The method of treating interest. There are three methods—

(*a*) where no interest is taken into account until the instalments repayable (which will actually include interest) have covered the principal sum lent;

(*b*) where interest is taken into account on each instalment;

(*c*) where interest is calculated per period of instalment, the amount repaid discharging principal and interest rateably, the former increasing and the latter decreasing with each instalment (on the same principle as Building Society repayments).

Illustration. M, a moneylender, commenced business on 1st January, 1952, and made the following loans—

1952

Jan. 1. To X, £120 plus Interest £24, repayable in twelve equal monthly instalments, commencing 1st February, 1952.

Mar. 1. To Y, £260 plus Interest £40, repayable in thirty equal monthly instalments, commencing 1st April, 1952.

Show how these transactions would be dealt with in the books of M for the year ended 31st December, 1952.

Method (a).

LOANS JOURNAL

		Principal	Interest
		£	£
1952 Jan. 1	X	120	24
Mar. 1	Y	260	40
		£380	£64
		(Credit to Bank)	(Credit to Interest Suspense)

Dr. BANK *Cr.*

			£				£
1952 (Feb. 1–Dec. 1)	To X		132	1952 Jan. 1	By X		120
(Apr. 1–Dec. 1)	„ Y		90	Mar. 1	„ Y		260

Dr. X *Cr.*

			Principal	Interest				Principal	Interest
			£	£				£	£
1952 Jan. 1	To Loan		120	24	1952 Feb. 1–Dec. 1	By Cash		120	12
					Dec. 31	„ Balance	c/d		12
			£120	£24				£120	£24
1953 Jan. 1	To Balance	b/d		12					

Dr. Y *Cr.*

			Principal	Interest				Principal	Interest
1952			£	£	1952			£	£
Mar. 1	To Loan . .		260	40	Apr. 1–Dec. 1	By Cash . .		90	
					Dec. 31	„ Balance. .	c/d	170	40
			£260	£40				£260	£40
1953									
Jan. 1	To Balance . .	b/d	170	40					

Dr. Interest Suspense *Cr.*

1952			£	1952			£
Dec. 31	To Profit and Loss . .		12	Dec. 31	By Sundries . .		64
	„ Balance . . .	c/d	52				
			£64				£64
				1953			
				Jan. 1	By Balance . . .	b/d	52

The Balance of this account will be offset against the balances of clients' accounts, as shown in the Interest columns (i.e. X, £12; Y, £40).

Method (b).

Journal, Day Book and Bank as in the previous method.

Dr. X *Cr.*

			Principal	Interest				Principal	Interest
1952			£	£	1952			£	£
Jan. 1	To Loan . .		120	24	Feb. 1–Dec. 1	By Cash . .		110	22
					Dec. 31	„ Balance. .	c/d	10	2
			£120	£24				£120	£24
1953									
Jan. 1	To Balance . .	b/d	10	2					

Dr. Y *Cr.*

			Principal	Interest				Principal	Interest
1952			£	£	1952			£	£
Mar. 1	To Loan . .		260	40	Apr. 1–Dec. 1	By Cash . .		78	12
					Dec. 31	„ Balance .	c/d	182	28
			£260	£40				£260	£40
1953									
Jan. 1	To Balance . .	b/d	182	28					

Dr. **Interest Suspense** *Cr.*

1952 Dec. 31	To Profit and Loss . .		£ 34	1952 Dec. 31	By Sundries . . .		£ 64
	,, Balance . . .	c/d	30				
			£64				£64
				1953 Jan. 1	By Balance . . .	b/d	30

Method (c).

The Cash lent would be entered in the usual way on the credit side of the Cash Book, but usually no interest would be brought into account until the end of the financial year of the moneylender.

The Ledger would be ruled as follows—

Dr. X *Cr.*

Date		Loan	Date	Principal	Interest	Cash	Monthly Balance
1952		£ s. d.	1952	£ s. d.	£ s. d.	£ s. d.	£ s. d.
Jan. 1	To Cash. .	120 0 0	Feb. 1	8 9 10	3 10 2	12 0 0	111 10 2
			Mar. 1	8 14 10	3 5 2	12 0 0	102 15 4
			Apr. 1	8 19 10	3 0 2	12 0 0	93 15 6
			May 1	9 5 2	2 14 10	12 0 0	84 10 4
			June 1	9 10 6	2 9 6	12 0 0	74 19 10
			July 1	9 16 3	2 3 9	12 0 0	65 3 7
			Aug. 1	10 1 11	1 18 1	12 0 0	55 1 8
			Sept. 1	10 7 10	1 12 2	12 0 0	44 13 10
			Oct. 5	10 13 11	1 6 1	12 0 0	33 19 11
			Nov. 1	11 0 2	19 10	12 0 0	22 19 9
			Dec. 1	11 6 7	13 5	12 0 0	11 13 2
		£120 0 0		£108 6 10	£23 13 2	£132 0 0	
	[a + b = c + d]	(a)			(b)	(c)	(d)

The total of the interest received will be entered in the Interest Journal, the total of which will be posted to the Credit of Interest on Loans Received account at the end of the year.

If thought desirable, the monthly figures may be entered instead of waiting till the end of the year.

Alternatively, the balance of interest accrued for December may be brought into account, bringing the accounts to an "Earned" basis, subject to suitable provision for default.

The rate of interest is 35.1 per cent with monthly rests.

The last instalment payable 1st January, 1953, of £12 is made up of principal £11 13s. 2d. and interest 6s. 10d. The latter is arrived at as follows—

$$\frac{35{\cdot}1}{100} \times 233{\cdot}25 \times \frac{1}{12} \text{ shillings} = \frac{8{,}187}{1{,}200} = \underline{\underline{6s.\ 10d.}}$$

[The rate of interest is just over 7d. in the £ per month, as 5 per cent is 1d. in £ per month, therefore 35 per cent is 7d. in £ per month. The interest in the Interest column can be checked, e.g. 1st August, Interest £1 18s. 1d. is 7d. in £ on £65 3s. 7d. = £1 18s. + $\frac{1}{360}$ × £1 18s. = 1d., total £1 18s. 1d.]

The account for Y will be similarly constructed. The form of Ledger in method (*a*) and (*b*) will, in practice, be that indicated in method (*c*).

VENDOR'S GUARANTEES OF DEBTORS AND CREDITORS TAKEN OVER BY PURCHASER

A vendor may guarantee to the purchaser that—

(*a*) Debtors taken over will not produce less than a certain ***minimum*** sum and/or that

(*b*) Creditors taken over will be settled at a certain ***maximum*** sum.

The interpretation of such a guarantee is a *legal* matter (a fact that a candidate should always state) requiring guidance from a legal adviser. Subject to indicating this point, the candidate should work out the problem according to the following generally accepted principles—

(1) If the guarantee is contained in one document, the inference is that it must be taken as a *whole* so that the purchaser cannot obtain benefit from (*a*) by reason of receiving more than the minimum and charge up the loss arising in (*b*) by reason of the creditors being settled at a higher figure, and vice versa.

(2) Where a person is included in both the Debtors and Creditors and a part settlement arises by set-off, the sum set off must be regarded, as the case may be, as a receipt or payment, e.g.—

X is a debtor for £50 and a Creditor for £20, paying on account £25; if the £20 is used as a set off, the transaction is regarded as a receipt from X (debtor) £45 and a payment to X (creditor) £20, leaving a net balance as a Debtor of £5.

(3) As, in general terms, a creditor may in absence of agreed appropriation, set off a payment against any particular item owing by a debtor, even a statute-barred debt, the purchaser would naturally credit receipts to debts incurred since the purchase of the business and not to the debt taken over, so that the guarantee should embody some safeguard to the vendor of the business in this respect, as well as in respect of bad debts by reason of negligence in collection.

Where the old ledgers are continued by the purchaser, schedules should be prepared showing precisely the amounts involved.

There is no need to separate cash received from (or paid to) debtors and creditors, but discounts, allowances, bad debts, etc. must be so kept.

A difficulty arises where a provision for bad debts and discounts exists, as the purchaser may choose to make a provision differing from that made by the vendor, but this is not logical, the true provision being the excess of book debts transferred over the *guaranteed* amount. (The nominal amounts of book debts in the Sales Ledger will not be disturbed.) Similar principles apply to creditors in respect of discounts.

Illustration. Vendor on selling his business undertook (in one agreement) that the debtors per the Sales Ledger amounting to £4,500 would realize £4,100, and the creditors per the Purchase Ledger amounting to £3,600 would be settled for £3,500.

The accounts revealed that the bad debts, discounts, etc., allowed to debtors were £480; and allowed by creditors £160.

State the amount due by the vendor in respect of his guarantee.

It is assumed that, in all respects, the purchaser of the business has carried out his part of the bargain, and that all the taken over debtors and creditors have been fully dealt with, i.e. no outstandings remain.

The vendor is liable for £80, being the excess of the bad debts, etc., over the provision of £400 (£4,500–£4,100); but can claim the gain of £60 in respect of the profit on settlement of the creditors.

		£
The purchaser has lost by Bad Debts, etc.: £4,100 – £4,020 the latter being cash received [£4,500 – £480]	. =	80
The purchaser has gained by Discounts: £3,500 – £3,440 . the latter being cash paid [£3,600 – £160]	. =	60
Net		£20

If there were separate agreements (assuming they did not provide for the vendor claiming a gain on settlement of debtors or creditors), the vendor would be liable for £80 loss on debtors without being able to set off the gain on creditors.

INTERPRETATION OF ACCOUNTS

By interpretation of accounts is meant the explanation and amplification of, and translation into clear and simple form of the data presented by the Profit and Loss Account and Balance Sheet of a business; to make such deductions and draw such inferences as may be possible therefrom as to its operations, financial position, and prospects.

The examination of the Profit and Loss Account and Balance Sheet may arise—

(i) For a special objective, e.g. for the purpose of agreeing profits for taxation purposes or to enable an intending lender, e.g. a banker, to decide whether or not to lend.

(ii) For a restricted objective, e.g. criticism of form, content and conformity to law of published accounts.

(iii) To assess and interpret results of one year's operations.

(iv) To assess and interpret results for a period of years—

(*a*) broadly, by way of further explanation of (iii), and
(*b*) in detail, with some special object in view.

In practice, the most frequent form of interpretation is that arising under (iii) where the professional accountancy and financial periodicals make analyses and give interpretations of them, although the professional accountancy publications lean more to criticism of content and form rather than attempting interpretation.

The financial periodicals do not confine themselves necessarily to the requirements of (iii) and often attempt a very broad interpretation under (iv).

It will be recognized that in many instances full and complete detail will be available which will enable a comprehensive analysis and interpretation to be given, and problems that arise in the examination comprise those where considerable detail is available (although not necessarily complete) and those where full detail is *not* available (as in published accounts).

The main headings are now dealt with separately.

(I) Special Objective. Emphasis will be laid on the particular points relative to the inquiry and purpose.

The circumstances involving such inquiries are—

(1) On sale of a business.

(2) On the admission of a partner.

(3) On a potential investor being desirous of purchasing a block of shares.

(4) On the proposed acquisition by a company of a business.

(5) On a creditor or potential creditor, including a banker or a debenture-holder, being desirous of ascertaining what security is available for the advance or liability.

In circumstances (1) and (2), naturally the inquiry is chiefly directed to ascertaining to what extent the true position is actually better than the Balance Sheet disclosure, e.g. existence of secret reserve.

In circumstances (3) and (4) affecting a buyer, the reverse position obtains, the inquiry being weighted in ascertaining to what extent the true position is actually worse than the Balance Sheet disclosure, e.g. over-valuation of assets, including inadequate provision for depreciation.

In circumstance (5) the adequacy of the security is the chief consideration, particularly as to the likely position in the case of a forced realization of those assets that are "free" and those mortgaged or charged in favour of other creditors, so that he can measure the risk involved if he has to take secondary security or rank with unsecured creditors if no security is available.

Included in the enquiry will be, in cases (1) to (4), a consideration of earning capacity and goodwill; whilst in (5) it will be the capacity to earn sufficient income to pay the interest (or other reward) on the loan, and it would obviously not be sufficient unless the amount so required was covered by a very ample margin.

In all cases regard will be had to the liquid position, security of tenure, and the general trend of the company's profit and achievement.

Analysis of Components of a Balance Sheet. It is important that a student should be able to analyse and break down each component element in a Balance Sheet, that is, to consider it in detail and in relation to other items. The analysis (in summary form) of each item is now considered in the case of a limited company.

LIABILITIES SIDE

(1) *Share Capital.* Class of shares; issued at par, premium or discount; uncalled up capital; paid up Capital. Calls in advance; calls in arrear; interest and security for latter. Redeemable preference shares; rate and redemption (when and at what price); arrears of preference dividends; expropriation rights. Founder's shares. Forfeiture of shares; profit on reissue of forfeited shares.

Table A (Articles) *re* dividends; position as to dividends and winding up and generally respective rights and priorities; Lien; Nominal capital; uncalled Capital (charged). Reserve Capital, form (shares with distinctive numbers, stock, units of stock); expenses of issue. Share capital is *not* synonymous with *real* capital employed.

(2) *Debentures.* Nature; naked; charged (fixed and/or floating —if so, on what). Issued at par, premium or discount and how treated. Redemption by drawings, by purchase in open market or fixed date or piecemeal—when and what price; treatment of profit or loss on redemption. Sinking Fund; convertible, when and how. Interest; cover; margin of security. Own debentures redeemed reissuable; company's borrowing powers.

(3) *Creditors.* Trade; expenses (accrued and accruing). Lien; set-off; statute-barred. Discounts and other deductions. Class; secured or unsecured—former shown separately—details of charge. Loan creditors. Subsidiary companies separate. Taxation provision separate; also Bank and other short term borrowings separate. Contingent liabilities.

(4) *Bills Payable.* Separate; accommodation bills; maturities.

(5) *Bank Loans, Overdrafts, etc.* Separate. Security; interest. Purpose. Repayment. Limits on borrowing. If Cash in same bank, terms *re* set off. Rates of interest.

(6) *Reserves.* Purpose. Segregate from provisions. Whether represented by earmarked, readily realizable securities (Reserve Fund). Increase and source; decrease and how utilized. Capital Reserves separate from Revenue Reserves.

(7) *Capital Redemption Reserve Fund.* Consistent with nominal amount of preference shares redeemed without use of proceeds of new issue. Bonus shares.

(8) *Provisions.* Purpose; commitments, contingencies, diminution of assets; ascertainable specific requirements. Taxation provision, with basis, separate.

(9) *Profit and Loss Account.* Connect with balance forward; addition of current profit or deduction of current loss. Dividends, Reserves and other appropriations; taxation. Transfers from Reserves. Profits earned in relation to (*a*) share capital and (*b*) capital employed and comparison thereof with previous years.

ASSETS SIDE

(1) *Land and Buildings*. Valuation; revaluation. If leasehold, unexpired years; amortization; dilapidations; renewal; compensation. Location; site factors; size and capacity. Treatment of additions; improvements. Free or secured.

(2) *Plant and Machinery*. Cost; additions; sales. Depreciation; obsolete plant. Reconciliation with plant register. Free or secured.

(3) *Patents, Trademarks, etc*. How acquired; origin or transfer. Life. Effectiveness (reflecting true value). Depreciation. Fees.

(4) *Loose Tools*. Revaluation.

(5) *Fixtures and Fittings*. Cost; additions; sales. Depreciation. Renewals.

(6) *Stock*. Subdivision: Raw materials, work in progress, finished goods, stock out on consignment, sale or return; in Transit. Expenses stock (e.g. advertising material). Stock records; valuation; consistent treatment; by, when, or how taken, valued and certified. Free or Secured. Elimination of unearned profit on sale—price variations (e.g. Branches, goods from subsidiaries, etc.). No profit on finished goods or work in progress, and on latter, reasonable loading for overheads. On long term contracts, treatment according to proximity of completion; contract terms. Conservative treatment of old and "sticky" stock.

(7) *Debtors*. Total accounts. Home or foreign; if latter, currency or sterling debt; forward exchange contract. Nature. Realizability. Provision for bad and doubtful debts; discounts; set-offs and contras. Exclusion of "internal" debts: Proprietor, directors. Branch accounts. Loans to directors separate. Loans to subsidiary companies separate. Security; interest; repayments.

(8) *Bills Receivable*. Amounts and maturities; parties to Bills; provision for dishonoured Bills. Contingent Liability for Bills discounted. Nature and purpose.

(9) *Investments*. Subsidiaries separate. Trade Investments separate. General investment policy. Dividends. Purchases and sales cum or ex div. Recent sales or purchases. Earmarked for special purpose (e.g. sinking fund); dividend accruing to the fund or other special purpose. Free or secured; degree of realizability. Fixed or current asset. Quoted or unquoted. Valuation. Contingent liability for uncalled capital. Tax reserve certificates separate as current asset; interest accruing only when certificate surrendered before Balance Sheet is signed.

(10) *Goodwill*. Purchase. Valuation consistent with profit capacity. Write-offs, how dealt with; write-backs, how dealt with. No Balance Sheet inclusion for "created" as distinct from purchased goodwill.

(11) *Fictitious Assets*. Expenses of issue of shares and debentures, discount on same. Separate items.

Banker and the Balance Sheet. The Banker in lending must aim at protecting the amount he lends and the interest payments, so that the dominating factors are the security and realizability of the

loan and the borrower's ability to pay regularly the interest; hence the purpose and duration of the loan and the security available are of prime importance, as well as the standing, integrity and business record of the borrower, and the inherent soundness of the business.

In examining the Balance Sheet of a business to which he proposes to lend money he will consider—

(1) The reliability of the Balance Sheet and the extent to which it is truly representative of the financial position.

(2) Fixed and current assets—exclusion of fictitious and intangible items, and to what extent "free" or "encumbered."

(3) Working Capital.

(4) Amount and realizability of investments; such as may be considered "quick assets," like British Government securities, may be considered as falling under (3).

(5) Particulars of all liabilities, including taxation not only in respect of the current year's liability, but that arising on current earnings; whether and to what extent and under what conditions liabilities are secured on specific assets.

(6) Consideration of specific assets, e.g. debtors, stock, work in progress.

(7) The amount of drawings, if a sole trader or partnership, or directors' fees and dividends if a limited company.

(8) Existence and nature of contingent liabilities, e.g. calls on shares, forward purchases, etc.; secret reserves.

(9) Depreciation provision (the condition and modernness of the plant, etc., but this, as such, would not be ascertainable from the Balance Sheet).

(10) Profit earning capacity of the business.

As distinct from a prospective buyer of the business or of its shares, the Banker will pay close attention to the estimated "break-up" value of assets in a forced realization rather than "fair value as a going concern."

The Balance Sheet submitted would have to be "up to date" reflecting the position at the time of the loan negotiations.

Illustration. Field and Meadow, Ltd., desires to obtain from its bankers a loan of £20,000. The Balance Sheet representing the current position is as shown below.

You are asked by the bankers to investigate and report.

BALANCE SHEET

	£		£
Authorized and Issued Share Capital . 60,000 Shares of £1 each, fully paid.	60,000	Cash on hand .	100
Profit and Loss Account .	1,550	Sundry Debtors, *less* Provision for Bad and Doubtful Debts .	23,750
5% Debentures (Redeemable) – 180 of £100 each .	18,000	Stock and Work in Progress .	6,300
Sundry Creditors .	18,000	Investments and Loans (at Cost, *less* Provision) .	14,100
Bank Overdraft .	2,000	Plant and Machinery (at Cost, *less* Depreciation) .	8,300
		Leasehold Premises (at Cost) .	22,000
		Goodwill .	25,000
	£99,550		£99,550

Show the basic features of a report on the position, including those matters on which it is desirable to have fuller information.

It may be assumed that the bankers are satisfied about the general prospects of the business and the purpose of the proposed loan.

The main headings of the Report would be—

(1) The net asset position is £36,550, excluding goodwill and depreciation of the leasehold premises.

(2) Assuming that the investments and loans are not such as can be counted as liquid or near liquid assets, the working capital at £12,150 appears to be adequate, notwithstanding the unsatisfactory cash position. The size of the stock and work in progress is low as compared with the debtors, which seems to indicate either an exceptionally low level of stock, or that the company does not require heavy stocks, or that the debtors position is unsound by reason of overdue accounts, or by long credit facilities given by the company.

(3) No provision by way of sinking fund is being made for the redemption of the debentures, and, although there are investments and loans, these fall short of the debenture debt and do not provide a satisfactory basis for ensuring debenture redemption, although assuming their reasonable liquidity, they would at the current date partly meet the redemption, but in that event the item would be ruled out of the category of current assets.

(4) The amount standing to the credit of the Profit and Loss Account is small and no general reserve exists; this may signify a low earning capacity (which may be attributable to a weak liquid position which it is intended to remedy by the loan now asked for) or an abnormally high distribution of profits signifying a disregard for careful husbanding of resources.

The specific detailed inquiry would be directed to the following matters—

(*a*) Analysis of the recent (Manufacturing) Trading and Profit and Loss Accounts with particular attention to turnover, gross and net profit, directors' fees, dividends.

(*b*) The date of redemption of the debentures, and the price of redemption; inspection of debentures, nature of charges (if any) they carry on the company's assets.

(*c*) Detailed particulars of investments and loans; in respect of the former whether or not they are fully paid; present market value of investments; in respect of loans, to whom and on what terms; when repayable. Realizability of both investments and loans. In view of the poor liquid position why loans should be made by the company.

(*d*) The date and terms of the lease, including the tenure.

(*e*) General condition of the plant and machinery; whether any obsolete.

(*f*) Separate examination of Stock (there should be both Raw Materials and Finished Goods) and work in progress; its valuation,

particularly as to whether work in progress and finished goods include profit (not yet earned) or selling and distribution charges.

(*g*) Examination of schedule of book debts to see if there are any debts irrecoverable and if the provision is adequate.

(*h*) Examination of the schedule of creditors with particular regard to the period of credit, overdue liabilities including any which may be pressing by reason of actual or contemplated legal proceedings; whether it includes *all* liabilities, including adequate provision for taxation and arrears of debenture interest.

(*i*) General examination of the recent trend in relation to availability of labour, supplies of goods and continued likelihood of sales being maintained or increased.

Subject to the information arising from the above inquiries being satisfactory and proper security being given by the company (together with personal guarantees by the directors), the Report would be sufficiently favourable to enable the Bank to view sympathetically the request for a further loan of £20,000.

[In practice, the numerous inquiries would be made and dealt with prior to the drafting of the Report, so that a firm conclusion could be arrived at. In examinations, in the absence of exact data, the general principles should be stated and the queries set out; but it will not usually be possible to do more than suggest a tentative recommendation. It is sometimes objected that all the detail should be given, enabling the candidate to come to a firm conclusion; but, apart from considerations of space, a candidate's knowledge of the subject can be best tested by the setting of the "inexact" question.]

(II) Restricted Objectives. As this calls for criticism of form, content and conformity with law, it will be necessary to apply a knowledge of accounting principles and company law, which subjects have already been dealt with elsewhere in this book.

(III) Results of One Year's Operations. The interpretation of the results of the year's operations of companies from published accounts must be confined to the necessarily abridged detail contained therein, without access to, or means of obtaining further information, except that given in the Chairman's review. Such interpretation will take the form of explanation of and comment on the past year's results and the financial position at the end of the year, with such deductions as are possible in relation to the profit trend of the past few years.

In this connection, the usual comments in the press are confined to summarizing the year's profit, tax, allocation to reserves; stating the chief Balance Sheet changes; rate of profit earned and dividends declared; and broadly commenting thereon.

Where the published accounts are drawn up clearly, reliable interpretation is possible and the true profit, its disposition and its resultant influence on the Balance Sheet can be ascertained.

The Profit and Loss Account must show the normal trading results, abnormal and unusual items, income from trade investments, depreciation, auditors' and directors' remuneration, provision for taxation and transfers to and from Reserves. Where a holding

company is concerned, a group Profit and Loss Account built upon similar lines is required, subject to certain exceptions. The information given in the Profit and Loss Account is generally insufficient to reveal anything as to efficiency, turnover, and detailed overheads.

The Balance Sheet must show certain minimum detail (see page 799), (including, where applicable, a Group Balance Sheet, subject to certain exceptions), and the following matters will usually be the subject of comparison and comment—

(1) Adequacy of the working capital, and arising therefrom the strength or weakness of the cash position.

(2) The relative proportions of the fixed and liquid assets.

There are frequently some special or unusual matters requiring comment, e.g. charging to Profit and Loss Account items properly belonging to Profit and Loss Appropriation Account, e.g. Debenture Redemption Fund Contribution; or charging to the latter account items being neither charges to, nor appropriation of, profit, e.g. payments made to an Amortization Policy.

(3) The adequacy of the provision for depreciation.

(4) The provision for taxation including that based upon the current year's results.

(5) The existence of and alterations to general reserves.

(6) Consistency of accounting methods.

(7) The general overall picture of the current Balance Sheet.

In all the above, comparison with preceding years' accounts will be made, together with such inferences arising therefrom as may be possible, reflecting management ability and policy.

(IV) Interpretation of Results over a Period of Years. In a long term interpretation the line of approach is to explain the broad trends of the business, without giving undue attention to yearly variations, except where special circumstances otherwise demand.

From the inferences that can be made reliably, some measure of forecast is usually possible, but allowance will have to be made for those factors which might affect appreciably a short term comparison (e.g. transition from war to peace production) as distinct from those factors which might affect appreciably the long term position. The long-term factors may be deep-seated and fundamental, so as to exercise a permanent influence on the earning capacity of the business; or merely superficial and not sufficient to alter materially former earning power.

Even in the most comprehensive set of published accounts much conjecture is inevitable, often involving contradictory interpretations by commentators, but many points of obscurity are often clarified and explained by the Chairman's review, particularly those factors which cannot be revealed by an examination and analysis of the published accounts.

The following are the general inferences to be drawn from the examination of a series of yearly published accounts—

(1) Depreciation written off approximating to capital expenditure

—a fair inference is that fixed assets are being maintained, but factors lacking in coming to a definite conclusion are (*a*) adequacy of rate, (*b*) depreciation method adopted, and (*c*) degree of obsolescence.

(2) If profits do not vary considerably from one year to another a fair inference is that the business is stable, but factors lacking are (*a*) whether so called stability arises from deliberate policy of using or creating secret reserves; (*b*) the volume of sales and rate of gross earnings; (*c*) the consistency of stock valuations.

(3) A progressively increasing amount of fixed assets without a corresponding increase in net profit—a fair inference is that the assets are not paying their way, either because selling prices have not been adjusted to cover their enhanced cost, or through lack of full employment of such assets, e.g. short time, or assets employed with a short life with frequent replacements (particularly in periods of rising prices, e.g. second-hand vehicles).

(4) Where short-term liabilities, e.g. Bank Loans or Bank overdraft, do not decrease or actually increase, a fair inference is that the company's position continues to be sufficiently unattractive to support a "funding" operation by the issue of shares or debentures; if related to a constant or growing amount of fixed assets, and not compensated for by a corresponding increase in liquid assets, the company's position is likely to become vulnerable. Reference will have to be made to the profits earned, and, unless these are declining, the position may reveal a tendency to over-distribute dividends or to the utilization of the major part of retained profit in extending the acquisition of fixed assets or the increasing of the volume of credit business (or extended period of credit to customers) in extent greater than the financial position warrants. Other changes in policy may be indicated, i.e. transference from cash or normal credit sales to hire purchase sales (itself often evidence of financial weakness). The position may be reflective of continued decline in profit capacity (or actual losses) but this would be apparent from the examination of the published accounts.

(5) Where trade creditors (including adequate provision for taxation) are increasing as compared with debtors, a fair inference is that the company is overtrading. Where, in the past, under the heading of creditors were included "Credit balances" (like General Reserves), the practical effect was to create a secret reserve which might (and often did) cover periods of declining profits.

(6) Capital issues should normally, after due time for their utilization, be reflected in a corresponding increase of net profit and volume of business. If not, a fair inference is that the financial position is deteriorating, unless the issue is mainly for "funding" short-term liabilities (if for reducing liability to Bank, the issue would be followed by the elimination of the charge for Bank Interest or redeeming wholly or in part debentures and/or other prior charges, by the elimination or reduction in Debenture and/or Loan Interest).

(7) Where dividend *rates* are maintained, with regular and reasonable appropriations to Reserve, a fair inference is that the business is being conducted on sound lines, particularly if there appears to be adequate provision for depreciation, and the fixed assets are not being unduly increased and the ratio of liquid assets to current liabilities is maintained.[1]

(8) Where the working capital is declining, a fair inference is that the business is declining, or, if the fixed assets are unduly increasing, that the business is becoming "top heavy" and unstable on its foundations.

(9) Should the liquid assets and profit be increasing consistently, it may be fairly inferred that the business is expanding (but it may have been financed by borrowing on Loan or Share Capital so that the rate of dividend might not be correspondingly increased). If, however, the profits are increasing without a rateable increase in the liquid assets it may indicate any or all of the following factors—(*a*) higher profit margins; (*b*) quicker rate of turnover; (*c*) quicker discharge of current liabilities, or a utilization of profit for expansion of fixed assets or reduction of long term liabilities.

When a Holding Company's accounts are published, they now have to be supported by Group Accounts of such Holding Company and its subsidiaries, so that much of the guesswork of the past is now avoided. Recent publications of Group Accounts have disclosed for the first time the real position of the group as a whole particularly as regards combined profits, directors' renumeration and combined assets and liabilities. Apart from the disclosure of the main facts, the compulsory consolidation of group accounts (at one common terminal date) has eliminated many abuses, e.g. where one holding company (which drew up its accounts at a date different from that of its subsidiary) borrowed £4,000,000 from its subsidiary and repaid it to the subsidiary the day following the terminal date of its own accounts, so that the Balance Sheets both of the holding company and its subsidiary showed the same amount (approximately) of "Cash at Bank." In certain circumstances, an examination of the Balance Sheet together with the Profit and Loss Account will be required, not merely for formal and legal correctness, but for the purpose of ascertaining the real content (viewed from a particular angle according to the objective in question).

This work of examination will usually be undertaken in detail, going further than that of dealing with the normal published accounts of companies; and therefore much that is surmise in the latter will be classified and explained as a result of inquiry and investigation of the actual accounts.

Working Capital. It is essential that at any time a business should be in a position of stabilized solvency, that is, in a position to pay its debts as they arise, and in addition to take advantage of such

[1] The rate must be considered in the light of any Bonus Share issue, e.g. if a Bonus Share issue has been made in ratio of "1 for 2" and the old rate was 15 per cent, the equivalent rate after the Bonus issue is 10 per cent.

business opportunities as may occur and to meet any contingencies that may be reasonably visualized.

It will be realized in this connection that a business may have a large surplus of assets over liabilities, but if such assets are in the main fixed, there will probably be great difficulty in finding the ready cash to meet current liabilities without having recourse to borrowing (on the security of the fixed assets).

Working capital may be defined as the excess of current and liquid assets over current liabilities requisite in a business, having regard to reasonable provision for contingencies, so as to enable it to conduct its operations normally and free from financial embarrassment, and to avoid losses consequent upon incurring commitments beyond its capacity in the ordinary course of events.

The definition must be construed very broadly; many businesses are conducted quite successfully on a very small margin of working capital, indeed in some cases there is a deficiency, i.e. more current liabilities than current and liquid assets. The facts and circumstances of each case must be considered. Thus, it will be possible to carry on business with a small margin or even a deficiency in a case where goods are sold for cash, whilst being bought on credit terms, or where the sale credit period is shorter than the purchase credit period.

On the other hand, the position may be the reverse to such favourable circumstances; and the gap may be covered by short-term financing, bank overdrafts, and bills of exchange. Yet, merely having the advantage of a credit period or being able to finance sales does not necessarily bespeak the existence of working capital. As long as there exists a reserve of strength in the form of assets which can be converted into cash without undue delay or loss, a lack of working capital will not be detrimental to the business. Many businesses, particularly small ones, work "from hand to mouth," but without the reserve of strength required to meet special circumstances.

The assets which are included in working capital may be briefly classified as follows—

(1) Liquid—Cash in hand, cash at bank, readily realizable investments.

(2) Near liquid—Bank deposits where long notice of withdrawal is required, investments which are not so readily realizable as those in (1).

(3) Other current assets which may be classified under (1) or (2) according to the particular facts—debtors, bills receivable, stocks.

Any investment or cash which is held for a *specific* purpose must be excluded, for instance, where part is a sinking fund or pension fund. Moreover, the investments should be such as are convertible into cash without undue difficulty, i.e. those which are quoted or dealt in on the Stock Exchange and enjoy a reasonably good market; investments in private companies, trade investments,

investments in subsidiaries could not be included in the constitution of working capital. Similarly, bills of exchange should be readily convertible and should be short term in tenor and such as are received as *normal* payments from customers (and not substitutions for normal cheque payments).

From these "working" assets will be deducted the current liabilities and commitments of a short term nature, including creditors, bills payable, bank overdrafts, current expenses and tax including P.A.Y.E. Provided that the tax liability is, as it ought to be, included, Tax Reserve Certificates are quite properly regarded as part of the working capital, since in effect so much of the tax liability as is covered by these certificates can be regarded as having been discharged.

In attempting to estimate the amount of working capital required in a business, the following points will be considered—

(1) The normal average period of credit given to and allowed by the business.

(2) The amount of stock that is required to feed the business. The rapidity of turnover will be a vital element, e.g. normally a motor car vendor might have to hold a car in stock for say three months, but a retail tobacconist would be likely to hold his stock for no more than a few days. Hence it is desirable to compute the cost of estimated sales for the year and divide by the estimated number of times the stock is likely to be turned over.

(3) Provision for meeting the peak load of expenses, having regard to the amount of cash in hand or at bank, or other credit facilities available. In this connection the differential period of credit given and allowed is an important factor. In certain parts of the year heavy expenses, e.g. tax, will have to be paid (out of proportion to the *average* expenses) so that the marginal credit position cannot be ignored. If, for instance, debtors are allowed three months credit, but creditors allow only fourteen days, the gap must be provided for, particularly if at the same time heavy expenses coincide with payments for goods bought in a "buying" season, i.e. where the purchase of goods cannot be spread evenly. This gap will be even wider if a period of time must elapse before these heavy purchases are translated into actual sales, e.g. because of time required in manufacturing the finished product, and even more so if extended credit is given to customers.

(4) The running expenses of the business will have to be estimated and, subject to factors contained in (3), spread over the year.

(5) The credit-worthiness of the business will be a great factor in covering any gap in the working capital, as upon this will depend the extent to which recourse can be had to short term borrowing, e.g. through a temporary overdraft.

It is therefore important to examine the effect of the year's operations, not merely from the angle of the variation of the total capital structure but from that of the *working* capital structure.

An examination not only of the Balance Sheet, but of the Trading and Profit and Loss Account (and Appropriation Account) must be made to connect the opening and closing working capital.

The build up will be the opening working capital, plus—

(*a*) Profit, before the debits of a non-financial nature, such as depreciation, loss on sale of fixed assets and transfers to General Reserve, and before credits of a similar nature such as profit on sale of fixed assets and transfers from General Reserve to Profit and Loss Account.

(*b*) Increase of loans, debentures, share capital and realizations of fixed assets from which will be deducted

(*c*) Reductions of items indicated in (*b*).

Illustration.

	1951	1952
	£	£
Net Liquid Resources	5,200	5,900
Fixed Assets	3,000	2,800
	£8,200	£8,700
Share Capital	5,000	5,000
Profit and Loss	3,200	3,700*
	£8,200	£8,700

* After Depreciation, £200.

The increase in the Net Liquid Resources (£5,900–£5,200) of £700 is made up of (*a*) profit of £500 (£3,700–£3,200) plus depreciation £200.

In general terms, any capital expenditure in that year should, in order to maintain working capital, be confined to £700, any additional expenditure being by way of permanent financing (share capital) or long term borrowing.

The foregoing illustration serves merely as a guide to the general principle. The composition of the item net liquid assets is important because (*a*) the assets themselves will not necessarily be mainly cash on hand and at Bank, as they will also comprise debtors, stock, etc., and (*b*) there will be current liabilities falling to be deducted, so that there may result a minus "cash" position.

Illustration.

	1951	1952		+ or −
	£	£		£
Stock	4,200	5,700	+	1,500
Debtors	7,900	8,300	+	400
Bank	1,000	—	−	1,000
	13,100	14,000	+	900
Current Trade Liabilities	8,300	7,100	−	1,200
Bank Overdraft	—	600	+	600
	£4,800	£6,300	+	£1,500

Assuming there were no non-financial transactions, except a depreciation charge of £400, the profit after such charge would be £1,100.

The "Cash" position may be tabulated as follows—

	£	£
Increase of Stock and Debtors		1,900
Decrease of Current Trade Liabilities . .		1,200
		3,100
Net Profit	1,100	
Depreciation	400	
		1,500
Decrease of "Cash" Resources .		£1,600

This is reflected in the conversion of the opening item Cash at Bank £1,000 into the closing item Bank Overdraft £600.

Illustration.

TRADING AND PROFIT AND LOSS ACCOUNTS

		1951 £	1952 £			1951 £	1952 £
To Stock . . .		21,000	24,000	By Sales . . .		137,000	162,000
" Purchases . .		93,000	107,000	" Stock . . .		24,000	28,000
" Gross Profit . .	c/d	47,000	59,000				
		£161,000	£190,000			£161,000	£190,000
To General Expenses .		31,000	38,500	By Gross Profit . .	b/d	47,000	59,000
" Depreciation . .		4,000	3,500				
" Net Profit . .	c/d	12,000	17,000				
		£47,000	£59,000			£47,000	£59,000
To Taxation . .		9,600	12,000	By Balance . .	b/f	4,200	1,000
" General Reserve .		3,000	1,000	" Net Profit . .	b/d	12,000	17,000
" Dividends . .		2,000	3,000				
" Goodwill written off.		600	400				
" Balance . . .	c/f	1,000	1,600				
		£16,200	£18,000			£16,200	£18,000

BALANCE SHEETS

	1951	1952		1951		1952	
	£	£		£	£	£	£
Issued Capital	50,000	50,000	Fixed Assets .	60,100		58,100	
Profit and Loss	1,000	1,600	Additions . .	2,000		14,400	
General Reserve	4,500	5,500					
Debentures	20,000	25,000		62,100		72,500	
Current Liabilities . . .	23,000	29,500	Depreciation .	4,000		3,500	
Provision for Taxation . .	12,100	17,500			58,100		69,000
			Current Assets .		46,500		54,500
			Preliminary Expenses . .		1,000		1,000
			Goodwill . .		5,000		4,600
	£110,600	£129,100			£110,600		£129,100

Set out the variations in Capital and Surpluses, showing the connection between the two.

Summary of Change during 1952—

		1951	1952	
		£	£	£
Liquid Assets		46,500	54,500 +	8,000
Current Liabilities		35,100	47,000 +	11,900
Net Liquid Resources	(*a*)	£11,400	£7,500 −	£3,900
Fixed Assets		58,100	69,000 +	10,900
Debentures		20,000	25,000 +	5,000
Net Fixed Assets	(*b*)	£38,100	£44,000 +	£5,900
Capital Employed	(*a*) + (*b*)	£49,500	£51,500 +	£2,000

Reconciliation—

	1951	1952	
	£	£	£
Issued Capital	50,000	50,000	—
Profit and Loss	1,000	1,600 +	600
General Reserve	4,500	5,500 +	1,000
	55,500	57,100 +	1,600
Less Preliminary Expenses	1,000	1,000	
,, Goodwill	5,000	4,600 −	400
	£49,500	£51,500 +	£2,000

Statement of Source of Increase of Capital—

	£	
Increase of Credit Balance of Profit and Loss	3,600	(*d*)
General Reserve	1,000	
Goodwill w/o	400	
	5,000	
Less Dividend	3,000	(*c*)
Increase	£2,000	

Statement of Source of Decrease of Net Liquid resources—

	£	£	
Addition to Fixed Assets		14,400	
Dividend		3,000	(*c*)
		17,400	
Less Increase of Credit Balance of Profit and Loss	3,600	(*d*)	
,, General Reserve	1,000		
,, Goodwill w/o	400		
,, Debentures Issued	5,000		
,, Depreciation	3,500		
		13,500	
Decrease		£3,900	

[The increases of Profit and Loss shown in the Balance Sheet is the excess of (*d*) over (*c*).]

Changes in Assets—

		£
Increase of Liquid Assets		8,000
Increase of Fixed Assets		10,900
Total Increase of Assets		£18,900

Source of Increase—

	£	£
Creditors:		
Liquid (Current) Liabilities		11,900
Fixed (non-Current) Liabilities		5,000
Total Increase in Creditors		16,900
Profits:		
Increase of Profit and Loss	3,600	
General Reserve	1,000	
Goodwill w/o	400	
	5,000	
Less Dividend	3,000	2,000
		£18,900

Thus, additions to fixed assets of £10,900 have used up the additional loans of £5,000, and have been financed by (*a*) an increase of *current* liabilities of £3,900 (as below); and (*b*) the profit of £2,000.

The additions to the liquid assets are £8,000 reflected in an increase of £11,900 in current liabilities, thus leaving an increase of £3,900 to finance partially the fixed assets.

The fixed assets increase (before depreciation) is £14,400 which is compensated by the addition of depreciation of £3,500 in the schedule of profit.

Preparation of Working Capital Statement. The question of working capital, with emphasis on the liquid cash position, is particularly important in the early stages of a business, as there will probably be rapid expansion until normal factors operate.

A schedule will be prepared to estimate the monthly or weekly inflow and outflow of cash, the former comprising cash sales and receipts from debtors, the latter cash purchases and payments to creditors and of overheads. The payments to creditors are likely to be abnormal for a short period by reason of the necessity for building up minimum stocks (subject to any extended credit given by suppliers), but unless the business is working at a loss or expansion is too rapid, the liquid position will improve.

If there is a deficiency in any week or month, that is, an excess of payments over receipts and cash in hand and at bank, its amount is the minimum working capital required, and where there is a deficiency in more than one period, the highest individual figure will be taken.

In dealing with the foregoing, due regard must be had to contingencies and to periodical payments such as taxation. Unless these are considered a business may be showing an apparent amplitude of working capital which may be unjustifiably used for further development.

Illustration. X, Y and Z are considering the formation of a company for manufacturing and selling a certain commodity and submit the following information to you—

(*a*) Cost of Factory £32,000; the vendor agreeing to accept one-quarter of the purchase price in 4½ per cent Mortgage Debentures in the proposed company.

(*b*) Cost of installing Plant, etc., expected to be £9,000, all payable in cash within one month of the formation of the company.

(*c*) The prime cost of the commodity produced expected to be 5s. for labour and 10s. for materials, the latter being purchased on terms for payment in the month following delivery. [In the first month the labour charge worked out at 10s. instead of 5s., but the selling price was not amended, the extra cost being regarded as abnormal.]

(*d*) The selling price expected to show 33⅓ per cent gross profit on prime cost, and sales expected—

	Units		*Units*
First month .	2,400	Third month . .	3,200
Second month .	2,800	Subsequent months .	3,200

One-quarter of such sales expected to be for cash, balance on credit for settlement month following sale.

(*e*) It is estimated that a stock of raw materials, totalling £6,000, and 1,600 units of finished goods will be required at the commencement of trading and these levels will be maintained.

(*f*) Overhead charges expected to be £400 per month payable in cash during the month, increasing at the end of the third month by 25 per cent.

(*g*) A margin of £1,000 is to be allowed over and above the minimum cash requirements (to nearest even thousand pounds), it being assumed that the credit terms will be strictly adhered to and no short term finance will be used.

(*h*) Preliminary expenses expected to be £1,800 payable in cash immediately the company is formed.

(*i*) The share capital to be in the proportion of four-fifths in ordinary shares of £1 each (issued at 24s. payable in full on allotment) and one-fifth in 6 per cent redeemable preference shares of £1 each at par (payable in full on allotment) and redeemable at par by equal annual drawings over 16 years.

In consideration of services rendered, etc., an allotment is to be made to X, Y and Z equally at par to the extent of one-sixteenth of the ordinary share capital to be in issue.

(*j*) Preliminary expenses are to be written off against share premium. You are required (i) to compute the capital required and its division into the various classes; and (ii) to submit a *pro forma* Balance Sheet (showing how you arrive at the figures you use), assuming the foregoing arrangements have been carried out and the estimates realized, as at the end of six months' trading (which commenced immediately the company was formed). Ignore taxation and depreciation.

Capital required—	£	£
Factory	32,000	
Less 4½% Mortgage Debenture	8,000	
		24,000
Installation		9,000
Preliminary Expenses		1,800
Stock: Raw Materials	6,000	
Finished Goods, 1,600 units at, say, 15s. .	1,200	
		7,200
		42,000
Working Capital	1,000	
Add Margin	1,000	
		2,000
		£44,000

Division—

	£
6% Redeemable Preference Shares	8,000
30,000 Ordinary Shares of £1 each issued at 24s. per share. [Premium on shares, £6,000; Ordinary Share Capital, £30,000.]	36,000

Dr. CASH *Cr.*

	£		£
To Receipts of Share Capital . .	44,000	By Payments—	
„ Trading Receipts	15,600	Capital per Schedule . . .	42,000
		„ Trading Payments . . .	15,200
		„ Balance	2,400
	£59,600		£59,600

Dr. ORDINARY SHARE CAPITAL *Cr.*

			£
		By Cash	30,000
		„ X, Y, and Z	2,000
			£32,000

Dr. PRELIMINARY EXPENSES *Cr.*

	£		£
To Cash	1,800	By Share Premium	3,800
„ Share Capital	2,000		
	£3,800		£3,800

Cr. SHARE PREMIUM *Cr.*

	£		£
To Preliminary Expenses . . .	3,800	By Cash	6,000
„ Balance	2,200		
	£6,000		£6,000

Dr. TRADING AND PROFIT AND LOSS ACCOUNT *Cr.*

	£	£		£	£
To Costs—(See page 1333)			By Sales—		
Cash	15,200		Cash		4,500
Creditors . . .	1,600		Credit[1]	11,100	
		16,800	Debtors[2]	2,400	
„ Mortgage Interest . .		180			13,500
„ Net Profit		1,020			
		£18,000			£18,000

[1] Months 1–5, Cash received. [2] Month 6, receivable in Month 7.

Statement of Working Capital

Month	Raw Materials		Wages		Overhead Charges	Total	Cash Sales		Credit Sales		Total	Deficiency	Surplus
	Units	£	Units	£	£	£	Units	£	Units	£	£	£	£
1			2,400	(a) 1,200	400	1,600	600	600			600	1,000	
2	2,400	1,200	2,800	700	400	2,300	700	700	1,800	1,800	2,500		200
3	2,800	1,400	3,200	800	400	2,600	800	800	2,100	2,100	2,900		300
4	3,200	1,600	3,200	800	500	2,900	800	800	2,400	2,400	3,200		300
5	3,200	1,600	3,200	800	500	2,900	800	800	2,400	2,400	3,200		300
6	3,200	1,600	3,200	800	500	2,900	800	800	2,400	2,400	3,200		300
		£7,400		£5,100	£2,700	£15,200		£4,500		£11,100	£15,600	£1,000	£1,400

Proof of Profit—

	£
Excess of Receipts over Payments in Trading (£1,400 − £1,000)	400
Excess of Debtors over Creditors (£2,400 − £1,600)	800
	1,200
Less Debenture Interest provision	180
Net Profit	£1,020

Proof of Gross Profit—

	£	£	£
Sales per Profit and Loss			18,000
Less Cost per Profit and Loss		16,800	
Deduct Overhead Charges	2,700		
,, Abnormal Wages (see (a) above)	600		
		3,300	
			13,500
Gross Profit, being 33⅓ per cent on £13,500			£4,500

i.e. Net Profit of £1,020 + £180 + £2,700 + £600)

X, Y, AND Z, LTD

Pro Forma Balance Sheet at

	£	£	£		£	
Authorized Share Capital .				**Fixed Assets, at Cost—**		
Issued Share Capital—				Factory	32,000	
8,000 6% Redeemable Preference Shares of £1 each, fully paid (redeemable by equal annual drawings over 16 years) .	8,000			Installation	9,000	41 000
32,000 Ordinary Shares of £1 each, fully paid .	32,000			**Liquid Assets—**		
		40,000		Cash .	2,400	
Share Premium Account	6,000			Debtors	2,400	
Less Preliminary Expenses written off	3,800			Stocks	7,200	
		2,200				12 000
Profit and Loss Account		1,020				
			43,220			
4½% Mortgage Debentures (secured on Fixed Assets)			8,000			
Current Liabilities—						
Trade Creditors		1,600				
Interest on Debentures		180				
			1,780			
			£53,000			£53 000

The number of shares taken up by X, Y, and Z is 2,000, being one-sixteenth of the shares in issue, 32,000. If the shares to be taken up are one-sixteenth of the shares *already* in issue, the number would be $\frac{1}{16}$ of 30,000 = 1,875.

Illustration. From the particulars given below prepare Quarterly statement of X, Co. Ltd —

	30th June	30th Sept	31st Dec
	£	£	£
Freehold Premises	5 000	5,000	5,000
Plant and Machinery	4,200	4,500	4,500
Fixtures and Fittings	1,800	1,800	1,800
Motor Vehicles	800	800	800
Goodwill	3 000	3,000	3,000
Cash at Bank	1,050	850	1,460
Debtors	4,200	5,400	4 840
Stock	8,100	9,250	8,560
Current Liabilities	1 700	3,100	1,800
Bank Loan	2,000	2,000	2,000
Taxation	2,300	(see below)	(see below)
Mortgage on Freehold Premises	2,000	2,000	2,000
Additional Plant		300	
Purchases		17,150	13,710
Sales		20,000	18,000
Depreciation—			
Plant and Machinery		160	60
Fixtures and Fittings		40	40
Motor Vehicles		20	20

Taxation to be built up at 11s in £ (estimated to cover Income Tax an Profits Tax) on profit for each quarter.

X Co., Ltd. Quarterly Statement

	30th June		+	−	30th Sept.		+	−	31st Dec.	
	£	£	£	£	£	£	£	£	£	£
Fixed Capital—										
Freehold Premises		5,000				5,000				5,000
Plant and Machinery		4,200	300	160		4,340		60		4,280
Fixtures and Fittings		1,800		40		1,760		40		1,720
Motor Vehicles		800		20		780		20		760
Goodwill		3,000				3,000				3,000
		14,800	300	220		14,880		120		14,760
Less Mortgage on Freehold Premises		2,000				2,000				2,000
		£12,800	£300	£220		£12,880		£120		£12,760
Working Capital—										
Cash and Bank		1,050		200		850	610			1,460
Debtors		4,200	1,200			5,400		560		4,840
Stock		8,100	1,150			9,250		690		8,560
		13,350	2,350	200		15,500	610	1,250		14,860
Less Current Creditors	1,700		1,400		3,100			1,800	1,300	
" Bank Loan	2,000				2,000				2,000	
" Taxation	2,300		456		2,756		572		3,328	
		6,000				7,856				6,628
		£7,350	£494	£200		£7,644	£38	550		£8,232
Summary—										
Net Fixed Capital		12,800	300	220		12,880		120		12,760
Working Capital		7,350	494	200		7,644	38	550		8,232
		£20,150	794	£420		£20,524	38	£430		£20,992
			420				430			
[See Note *re* Taxation]			+ £374				+ £468			

Calculation of Stocks—

		£	£		£	£
Opening Stock		8,100			9,250	
Purchases		17,150			13,710	
Gross Profit (25% of Cost of Sales) (20% of Sales)	(*a*)	4,000		(*b*)	3,600	
			29,250			26,560
Net Sales for Quarter			20,000			18,000
Estimated Stock at end of Quarter			£9,250			£8,560

(*a*) $\frac{1}{5} \times (29,250 - 9,250) = £4,000$ (*b*) $\frac{1}{5} \times (22,960 - 8,560) = £3,600$

Taxation.

(i) Quarter ended 30th September. Increase of £456 (£2,756 − £2,300).

(ii) Quarter ended 31st December. Increase of £572 (£3,328 − £2,756).

(i) $£456 = \frac{11}{9} \times £374$ or $\frac{11}{20}(374 + 456) = \frac{11}{20} \times £830$.

(ii) $£572 = \frac{11}{9} \times £468$ or $\frac{11}{20}(468 + 572) = \frac{11}{20} \times £1,040$.

Balance Sheet Interpretation by Comparative Columns. In order to obtain useful results it is advisable to compare a present Balance Sheet with those drawn up in the past; and this is usually and most conveniently done by tabulating the main groups of figures and converting them into index figures. Therefrom will be deduced the various changes and their significance, such changes being reconciled with the yearly amount of profits (or losses) disclosed in the published Balance Sheets. The question of interpretation has already been dealt with and this paragraph is confined merely to ratios and indices.

The general principles may now be demonstrated by the employment of the following two Balance Sheets in abridged form.

BALANCE SHEET AS AT 31ST DECEMBER

	1951 £	1952 £		1951 £	1952 £
Share Capital—			Fixed Assets—		
Preference	12,500	13,500	Goodwill	6,000	6,000
Ordinary	10,000	10,000	Buildings	9,000	8,700
General Reserve	10,000	11,000	Plant and Machinery	5,000	7,200
Profit and Loss Account	8,200	9,550			
				20,000	21,900
	40,700	44,050	Current Assets—		
Debentures (secured on Buildings)	8,000	5,000	Stock	2,000	9,000
Current Liabilities—			Debtors	12,100	7,700
			Prepayments	300	200
Creditors: Trade	17,000	18,000	Investments—		
Expenses	300	250	Government Securities	8,400	4,700
Bills Payable	2,000	4,500	General	8,000	12,000
			Cash in Bank	7,200	11,300
			Development and Research Account	10,000	5,000
	£68,000	£71,800		£68,000	£71,800

Show (1) Comparative Balance Sheets in tabular form.
(2) Variations in the main groups of Assets and Liabilities.

COMPARATIVE BALANCE SHEETS AS AT 31ST DECEMBER

		£	1951		£	1952	Increase or Decrease of Groups £
Current Assets[1]—							
Bank		7,200			11,300		
Debtors		12,100			7,700		
Prepayments		300			200		
Stock		2,000			9,000		
Investments[2]		16,400			16,700		
			38,000			44,900	+6,900
Less Current Liabilities—							
Creditors: Trade		17,000			18,000		
Expenses		300			250		
Bills Payable		2,000			4,500		
			19,300			22,750	+3,450
Fixed Assets—			18,700			22,150	+3,450
Buildings	£9,000			£8,700			
Less Debentures	8,000			5,000			
		1,000			3,700		
Plant and Machinery		5,000			7,200		
			6,000			10,900	+4,900
Net Tangible Assets			24,700			33,050	+8,350
Intangible Assets—							
Goodwill		6,000			6,000		
Development and Research Account		10,000			5,000		
			16,000			11,000	− 5,000
			£40,700			£44,050	+£3,350

Represented by—

		£	£		£	£	£
Capital—							
Preference Shares		12,500			£13,500		
Ordinary Shares		10,000			10,000		
Undistributed Profits—			22,500			23,500	+1,000
Reserve		10,000			£11,000		
Profit and Loss Account		8,200			9,550		
			18,200			20,550	+2,350
			£40,700			£44,050	+£3,350

[1] These may be further subdivided into liquid and non-liquid assets.
[2] Assumed that the general investments are marketable.

The foregoing variations may be expressed in the following form—

CURRENT ASSETS AND CURRENT LIABILITIES

	Assets	Liabilities	Balance	
			Surplus	Deficiency
	£	£	£	
1951	38,000	19,300	18,700	
1952	44,900	22,750	22,150	

[The variations in fixed assets and fixed liabilities may be similarly shown.]

The variations may be shown in terms of a ratio of the surplus of current assets over current liabilities (or conversely), thus—

	Ratio	Index [using 1951 as 100]
1951 . . .	197 i.e. $\frac{38,000}{19,300} \times 100$	100
1952 . . .	197 i.e. $\frac{44,900}{22,750} \times 100$	100 $\left[\text{i.e. } \frac{197}{197} \times 100\right]$

The ratio and index in 1953 would be, assuming that the current assets and current liabilities were £33,140 and £21,500, as follows—

	Ratio	Index [using 1951 as 100]
1953 . . .	154 i.e. $\frac{33,140}{21,500} \times 100$	78 $\left[\text{i.e. } \frac{154}{197} \times 100\right]$

The ratios and indices in 1954, 1955, 1956, and 1957 would be, on the basis of the following figures, as below—

	1954	1955	1956	1957
	£	£	£	£
Current Assets . . .	39,500	42,200	35,000	32,150
Current Liabilities . . .	22,000	20,750	23,500	27,000

	Ratio	Index [using 1951 as 100]
1954 . . .	180 i.e. $\frac{39,500}{22,000} \times 100$	91 $\left[\text{i.e. } \frac{180}{197} \times 100\right]$
1955 . . .	203 i.e. $\frac{42,200}{20,750} \times 100$	103 $\left[\text{i.e. } \frac{203}{197} \times 100\right]$
1956 . . .	149 i.e. $\frac{35,000}{23,500} \times 100$	76 $\left[\text{i.e. } \frac{149}{197} \times 100\right]$
1957 . . .	119 i.e. $\frac{32,150}{27,000} \times 100$	60 $\left[\text{i.e. } \frac{119}{197} \times 100\right]$

Illustration.

X LTD. BALANCE SHEET FOR YEAR TO 31ST DECEMBER, 19..

Liabilities		£	*Assets*	£
Capital—			Sundry Debtors and Sundry Debit Balances	57,050
100,000 7% Redeemable Preference Shares of £1 each fully paid	£100,000		Stock-in-trade	37,200
50,000 Ordinary Shares of £1 each	50,000		Cash	1,000
		150,000	Buildings, Plant, Goodwill, Patents, etc.	97,300
5% Debenture Stock at Issue Price of 95		19,000	Preliminary Expenses	8,200
Bank Overdraft		14,000	Loans to Directors	18,400
Sundry Creditors, Reserves, and Credit Balances, including Reserve for Debtors		101,100	Investments and Loans in Subsidiary Companies *less* Repayments and Loans from Subsidiary Companies	110,250
Profit and Loss Account *less* Income Tax		36,550	Calls in Arrear	250
		£329,650		£329,650

(See page 1339.)

BALANCE SHEET CRITICISM

Problems are frequently set in connection with limited company Balance Sheets calling for criticism, in so far as they relate to the proper compliance with legal requirements. Such criticisms call for a thorough knowledge of what may be termed the "published accounts provisions" of the Companies Act, 1948. The questions put before the student may contain, in addition, points that are common to all Balance Sheet questions, e.g. heading, sequence, and classification of items: construction and interpretation.

The Balance Sheet on page 1338 is such a problem.

Suggest such suitable amendments as you consider are required, assuming that there is no question as to the accuracy of the figures presented.

[Actually, there is an error of £9,000 in the addition of the liabilities side of the Balance Sheet—a fact which must be noted in the answer.]

(*Institute of Chartered Accountants' Final.*)

(1) Form—

(*a*) Heading should be Balance Sheet at, as at, or as on, 31st December, 19...

(*b*) The layout of the Balance Sheet requires amendment to accord with the Companies Act. Assets and liabilities should be grouped under appropriate headings, e.g. Fixed Assets, Current Assets, etc. The general headings "Assets" and "Liabilities" are then unnecessary.

(*c*) Sundry debtors should not include sundry debit balances, as these may be purely fictitious assets, and in any case may be of such a nature as to require disclosure under the Companies Act, 1948, whilst deducted therefrom should be the provision for debtors now merged with the item "Sundry creditors, including reserve for debtors."

(*d*) Calls in arrear are usually deducted from share capital.

(*e*) The item of creditors includes reserves and credit balances, which may be true liabilities requiring separate disclosure and classification as to class of creditors and provisions under the Companies Act, 1948, or may represent part of the undistributed profits of the company. No amount is given for future taxation reserve.

(*f*) The Profit and Loss Account should be linked up with the balance brought forward from the preceding year.

(2) Legal Requirements—

(*a*) *Buildings, Plant, Goodwill, Patents, etc.* The two latter items must be stated separately from the former, provided that their amount can be ascertained either from (i) books of the company; (ii) contract of sale; or (iii) document relating to stamp duty.

The basis of valuation of fixed assets must be stated (e.g. cost or valuation, less accumulated depreciation).

The total amount of Goodwill, Trade-marks, and Patents may be shown under one heading (not necessarily separately).

The items comprised in the "etc." must be dealt with and, if necessary, shown separately.

(*b*) *Loans to Directors*. Illegal unless covered by the exemptions laid down by Sect. 190. If advances or repayments have been made during the year, the Balance Sheet must show the total advances or repayments; and in the case of loans made prior to the period to which the accounts relate which are still outstanding, the amount thereof must be shown.

(*c*) *Investments*. The law requires to be shown separately (i) investments in, (ii) loans to, (iii) loans from, subsidiary companies, (iv) trade investments, (v) quoted investments, (vi) unquoted investments with the valuations required by Part I of the 8th Schedule to the Companies Act, 1948. The amount of £110,250 will be increased by the loan from the subsidiary company and the latter shown separately as a liability.

(*d*) *Capital*. Details of the nominal capital are required.

(*e*) *Redeemable Preference Shares*. The earliest date on which the company has power to redeem must be stated.

(*f*) *Calls in arrear*, as mentioned, are usually deducted from the share capital, although the method adopted in the above Balance Sheet does not infringe any legal principle.

(*g*) *Five per Cent Debenture Stock*. The debenture stock should be shown at £20,000, and the debenture discount disclosed separately as an asset till written off. If the Debenture Stock (as is probable) is secured on the assets of the company (unless secured by operation of law), this fact should be stated, although there is no obligation to specify the particular asset charged. If any debentures have been redeemed, but are available for reissue, particulars thereof must be shown.

(*h*) In addition to the criticism made in paragraph (1), the general nature of the liabilities should be shown, particularly as regards Provisions.

(*i*) The Balance Sheet must be signed by two of the directors, and the Auditors' Report must be annexed to the Balance Sheet; a Profit and Loss Account is also required.

(*j*) Corresponding figures required for preceding year.

(*k*) Group Accounts or alternative information on Subsidiaries is required.

In the absence of further information, it is not possible to enter into greater detail. Many queries might arise, e.g. included in creditors may be a debenture redemption fund represented by investments, which may be included somewhere in the assets side —possibly in the "etc." item or even under the investments, because the phrase "Investments and loans in subsidiary companies" may include investments held otherwise than as a holding company. It will be observed that there is a bank overdraft, and

possibly the bank holds as security some of the company's assets. The *fact* that the liability is secured on any asset of the company *must* be stated.

(3) INTERPRETATION—

Information concerning the profit of the year and the utilization of reserves is not disclosed in the Balance Sheet (e.g. as to depreciation, provision for tax, etc.); nor is the manner of its appropriation shown.

In order to obtain a fair comparison preceding years' Balance Sheets and Accounts should be available.

MECHANICAL AIDS IN ACCOUNTING

There is a growing use of mechanical devices in accounting routine and therefore it is necessary for the student to be familiar with those mainly in every day use. The benefits from their use are considerable, provided that they are fully efficiently and adequately employed. The full benefits will not ensue if—

(*a*) they are not operated by properly trained staff;

(*b*) there is insufficient work to keep the machinery fully employed;

(*c*) there is no corresponding efficiency in dealing with the work of the machines, where the ledger sheets are not arranged in proper sequence, or where the work of the operator is interrupted by having to replace one ledger by another, or where the material to be worked on is not within easy reach of the machine;

(*d*) the quantity of work involved is too small to justify the considerable outlay, i.e. on the purchase and upkeep of the machine, particularly where the labour-saving is trivial;

(*e*) there is inefficiency in organization.

Good organization is required to obviate—

(*a*) Dangers arising from the cards or loose leaves being lost, destroyed, misplaced or fraudulently substituted. No handwriting on the sheets tends to increase the latter risk.

(*b*) Original errors being undetected, as such errors will percolate automatically through the whole of the records based thereon and will not generally be discovered by the failure of one set of books to balance with another.

Office machinery can be divided into—

(*a*) Direct machinery, which is employed in the performing of the actual accounting entries, including statistical and financial records.

(*b*) Indirect machinery, which is ancillary to the direct machinery and of great assistance in preparing for or the checking of accounting entries.

(*c*) Auxiliary equipment, comprising the numerous devices and machines of use generally in the office routine.

Examples of (*a*): Burroughs posting machines; National accounting machines, Hollerith (and Powers) tabulating and sorting machines, book-keeping typewriters (from which can be prepared in one operation, the ledger entry, daybook entry, statement of account and other records, e.g. proof sheets for daily balancing).

Examples of (*b*): Elliott Fisher invoicing machines, comptometers, adding and calculating machines, carbotypes.

Examples of (*c*): duplicating machines, addressographs, typewriters, internal telephones, postal frankers, letter openers and sealers, signographs, dictating machines, dictographs, time recording machines, cheque protectors, numbering and coin sorting machines, photostats.[1]

In addition there can be added the more familiar types of machine and equipment like perforating machines, stamp affixers, cash registers, filing cabinets, and many others.

Advantages of Mechanized Accounting. (1) Saving of time and labour resulting in reduction of wages for office administration.

(2) Increase of accuracy in routine work, and elimination of errors.

(3) Greater legibility, neatness, and accuracy of recording.

(4) Assists division of labour.

(5) Records can be kept always up to date, enabling quick dispatch of invoices, statements, etc., and the speedier preparation of periodic and annual accounts.

(6) Facilitates, in conjunction with total accounts, daily Trial Balances and balancing generally.

(7) Constant flow of subsidiary records (as the slip system or its equivalent is used for posting, etc.).

(8) As original records will be made in duplicate (or triplicate) needless effort of time and labour avoided on copy work (and "reading over"), thus enabling interested departments to have their "copy" in good time.

(9) In very large concerns the reduction of routine staff will free a certain amount of floor space.

(10) Facilitation of extraction of supplementary data, e.g. financial, costing, budgetary, statistical.

Disadvantages. (1) Too much reliance upon the automatic accuracy of some of the direct machinery.

(2) The danger arising from a mistake of the person using a machine for the "original" record, as this will travel right through all records and would not be discovered by an "out of balance" discrepancy as in manual work.

(3) The danger of the operator becoming "mechanical" in ways and outlook.

(4) The high initial cost and upkeep.

[1] These machines, which enable photographs of documents—probates, wills, accounts, plans, etc.—to be taken quickly and the negatives stored in small space, are extremely useful and were invaluable in the last war.

(5) Possibility of fraud through fraudulent use of loose leaves and substitution of fictitious accounts without any guidance through examination of hand writing.

(6) Waste through inefficient use and neglect of upkeep of equipment.

Objective Accounting. Operations frequently arise involving the question as to whether they are to be regarded as part of a whole, or whether they are to be regarded as separate. In other words, whether the operations are joint or severable.

Sometimes there is clear external evidence of intention; sometimes no indication is available as to the intentions of the parties involved, in fact, in many instances even the parties themselves have no clear conception of what their intentions were.

In the absence of information, treatment should be on the basis of reasonable inference, having regard to changed circumstances, lapse of time, etc., and where no equal tenable solutions are available, the most conservative aspect should be taken.

The transactions in question may be simultaneous or resultant. As examples, the following may be said to give rise to a consideration of whether they are to be considered as one or several—

(i) X purchases a business and, in addition, purchases the business property. (A simultaneous transaction.)

(ii) X purchases the business *only* mentioned in (i) and later purchases the property (a resultant transaction).

(iii) X as in (i) buys the property and adjacent property at the same time as the business is acquired.

(iv) As in (iii) acquiring such property at a later date.

(v) An underwriter is allotted shares in part payment of underwriting and also acquires shares by "firm" underwriting.

(vi) X is a debenture-holder (with others) in a company which goes into liquidation. X, with his co-debenture-holders, takes over the security and forms a syndicate which later they sell.

(vii) X is paid a debt in foreign currency which he decides to hold, and later acquires further units of that foreign currency.

(viii) X buys shares in a company and later acquires further shares in that company.

In many cases, in practice, the need for a decision does not arise, but when it does, as for instance where there are third party interests, all the facts of the particular case will call for consideration.

In connection with "Objective Accounting" mention may be made of the growing tendency to departmentalize the profit or loss of a business in order to obtain greater efficiency and cut out unprofitable sections. For the profit of the business may be regarded in its simplest form as the accretion of net assets over a period, while subdivision of the business into separate departments—buying, manufacturing, selling, repairing (without going into great detail)—might reveal a profit in one and a loss in another.

The Economic Year. The tendency during recent years has been

to move the accounting year of businesses from the calendar year to the economic year, that is one commencing and ending with the business activities at their lowest ebb.

At the end of such a period the stock will be at the lowest, the cash at the highest (unless the period of credit is long) and the peak of sales over, thus enabling accounts for the year to be built up quickly and accurately. Where the period of credit given to customers is short, say, a month, accounts may be drawn up to the date of the expiry of such period.

The year end will be at the end of a natural period, e.g. the completion of a harvest of a farmer; end of the Christmas trade of a poultry business or at the end of a period dictated by business convenience, e.g. clearance sales after Christmas or Whitsuntide sales; after delivery of fireworks by fireworks manufacturer.

It may well be that a business may have more than one "season" or be engaged in several activities with different peaks and slack periods. In such cases, a decision will have to be taken on the balance of advantage as regards *final* accounts; but interim accounts may be prepared for each relevant period (for each department).

It will often happen, particularly in manufacturing concerns, that the buying season supervenes, so that, although it does not weaken the validity of the argument in favour of the accounting terminal date being at the end of the peak season, the advantage arising through having a peak cash and a nadir of stock will be offset by the increase of new stock bought and creditors therefor.

EXAMINATION HINTS

The reader who has worked carefully through the text should find himself well equipped to deal successfully with the problems arising in the examinations. Unfortunately, candidates do not spend a sufficient amount of time really mastering one type of problem, invariably skimming over the text (and "auditing" the illustrations instead of working them out), hoping to "revise" during the last few weeks or days prior to the examination, such work usually being carried out in a frenzied effort to cover the whole ground again in a very short period, and invariably succeeding only in creating a state of mental confusion.

No amount of exhortation and outlining a long list of rules will be of the slightest avail unless, during the period of his study, the student has succeeded in acquiring the rules by practice and experience. Most candidates have the benefit of the guidance afforded them by the several first-class correspondence courses, but usually candidates do not avail themselves fully of such help, particularly that given both in the study notes and through the corrected exercises or tests, which are invariably accompanied by carefully prepared models or solutions.

Hence the rules given below are intended to remind the reader

of the more important points to be observed, all of which will have been brought to his notice during the course of his study. These rules are not exhaustive and merely set out the more fundamental points.

(1) Answers should be outlined in a concise and readily readable form. This will be a help to the candidate himself in revising his answer (and amending if necessary) and also will facilitate the work of the examiner (giving him a chance to award fair marks). The judicious use of showing a vital point in BLOCK letters will help.

(2) Read the question carefully; it is not possible to generalize, but often it will help the student if he runs over the question broadly to see what the examiner WANTS THE CANDIDATE TO DO, before going into the matter in detail. Frequently, the details are somewhat involved, and the candidate will often find it easier to make a start in the right direction, if he knows what the examiner is asking him to do.

(3) The candidate must always remember that mere copy work earns no marks, and as his objective is to gain in the *time available* as many marks as he possibly can in the aggregate, he must rigidly avoid wasting time in perfecting work which is not "productive." In this connection the examiner will not object to the employment of reasonable abbreviations so long as he knows what they mean. It is generally better to aim at the aggregate result, rather than to attempt full marks on any one question.

(4) The problem that always confronts the candidate is how far he can leave the answer "in the air," that is, without a formal finish. No hard-and-fast rule can be laid down, but provided always that the basis of the answer is given, it is submitted that, once the stage has been reached when the candidate could leave the formal completion to a junior in the office, then it can be left and another problem tackled.

(5) It is our experience that candidates are singularly lacking in their knowledge of quick mental arithmetic, and they show a deplorable lack of practice in the exercise of this important factor, involving a very serious inroad into the time available to them in the examination. Where necessary, reasonable approximation may generally be made, but the *basis* of a computation or calculation, and the rough workings, MUST be shown.

(6) In most examination problems the candidate cannot gain anything like full marks unless he gives the necessary assumptions, comments and qualifications, and this applies with particular force to the "inexact" type of question, where, deliberately or otherwise, the examiner is vague and ambiguous in the wording of his question. It is at times almost a mental feat to understand what is required. No objection can be raised to a question where the ambiguity merely relates to the use of a single word, unless its employment makes the question difficult to understand, as the candidate is entitled in such circumstances to make reasonable assumptions and, having stated them, proceed with his answer

accordingly. It must also be remembered that, in certain cases, the vague question is the best method of testing the candidate's ability. In general, however, it is submitted that the candidate is entitled to know what is required of him.

(7) Where a problem involves a purely legal point, the answer should give effect to it. If the question gives facts which are identifiable with an established point of law (whether arising by Statute or Case law) the candidate must proceed accordingly, supporting his answer by reference to the Statute or decided case. Where, however, the point of law is one that is capable of different interpretations (in the absence of authority), the candidate should answer according to his view of such particular legal point, but emphasizing by way of note other possible solutions and indicating that in practice legal guidance might have to be obtained.

(8) As is known, the examiner gives due credit for style, layout, knowledge of English, etc., and, therefore, the candidate should make his answers with due regard to these matters. Apart from this reason, the candidate should realize that it is in his own interest to pay particular attention to alignment and spacing. (Most candidates persist in placing writing too near to figures. There should be ample space, as often the candidate will find during the course of his answer that he requires one or more inset columns for his figures.)

(9) In dealing with contentious matters a fair sense of neutrality should be observed, calling for a reasoned and balanced marshalling of the arguments on both sides, expressed in language that is clear, concise, and relevant.

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